The following instructions provide guidance for Federal Reserve Bank staff performing inspections of nonbank subsidiaries of bank holding companies that have been authorized to underwrite and deal in certain debt and equity securities that cannot be underwritten or dealt in by member banks directly (bank-ineligible securities). Section 20 of the Banking Act of 1933, commonly known as the Glass-Steagall Act, prohibits the affiliation of a member bank with a company that is ''engaged principally'' in underwriting or dealing in securities. The Board has ruled that member banks can be affiliated with nonbank securities companies if no more than 10 percent of the affiliate's total bank-eligible and bank-ineligible revenue is derived from underwriting and dealing in bank-ineligible securities. Such bank holding company securities subsidiaries have become commonly known as section 20 subsidiaries. These subsidiaries will be referred to as either a *''section 20'' or ''underwriting'' subsidiary* in the following discussion and procedures.

In accordance with industry practice, an underwriting subsidiary is generally considered to be obligated to make a market or deal in any security for which it serves as a principal underwriter. For many years the Board has considered dealing to be an activity prohibited by the Glass-Steagall Act. Accordingly, any reference to underwriting securities will also include *dealing* in securities unless the text pertains specifically to underwriting procedures or practices.

Over the past few years, the Board has repeatedly endorsed legislation designed to modify the Glass-Steagall Act in order to permit commercial banking organizations to compete with investment banks. Recommendations to Congress have been tempered by recognition of inherent conflicts between commercial and investment banking, as well as past practices or problems that preceded passage of the Glass-Steagall Act.

To prevent the recurrence of undesirable practices and manage the conflicts associated with combined commercial and investment banking, the Board advocates the adoption of strong ''firewalls.'' These are limitations and operating conditions intended to insulate, to a significant extent, affiliate banks and the federal safety net from risks associated with expanded securities powers. Thus, the Board imposed significant firewalls when it approved limited expansion of securities powers in 1987, and further buttressed them in its approval of applications to engage in underwriting any debt or equity security (except mutual funds) in 1989. Prior operational and managerial infrastructure review is required before exercise of these latter 1989 powers.

After gaining extended experience with section 20 companies, the Board subsequently, on October 30, 1996, eased or eliminated certain firewall restrictions, effective January 7, 1997, as follows:

1. The Board modified the prohibition on director, officer, and employee interlocks (the interlocks restriction) between a section 20 subsidiary and its bank and thrift affiliates by (a) eliminating a blanket prohibition on employee interlocks, (b) replacing a blanket prohibition on director interlocks with one limited to a majority of the board of a section 20 subsidiary and an affiliated bank, and (c) replacing the blanket prohibition on officer interlocks with one limited to the chief executive officer of each company.

2. The Board eliminated the restriction on a bank or thrift acting as agent for, or engaging in marketing activities on behalf of, an affiliated section 20 subsidiary (the cross-marketing restriction).

3. The Board eased the restriction on the purchase and sale of financial assets between a section 20 subsidiary and its affiliated bank or thrift (the financial assets restriction). The Board expanded an exception to the financial assets restriction for the purchase and sale of government securities to include any asset having a readily identifiable and publicly available market quotation that is purchased at that quotation.

On January 9, 1997, the Board further eliminated the firewall that required bank holding companies to seek approval before providing funds, in the form of capital, secured or unsecured extensions of credit, or transfer of assets, to their existing section 20 subsidiaries.

Accordingly, the primary focus of inspections will be to ensure that—

1. policies and procedures are in place at section 20 subsidiaries and their affiliates to ensure compliance with firewall provisions designed to facilitate safe and sound operations;

2. revenue limitations are adhered to, thus ensuring that section 20 subsidiaries are not engaged principally in underwriting or dealing in ineligible securities; and

3. examiners monitor the overall financial condition of the section 20 subsidiary for its impact upon the consolidated organization.

The Board has directed that the appropriate Reserve Banks undertake at least *annual inspections* of section 20 subsidiaries.

The inspection procedures are designed to prevent, to the extent possible, duplicating the procedures of a securities self-regulatory organization (SRO). In addition to requiring registration with the Securities and Exchange Commission (SEC) as a broker-dealer, securities law requires an underwriting subsidiary to become a member of at least one SRO. In turn, SROs are responsible for ensuring compliance with various SRO and SEC rules designed to ensure investor protection (for example, suitability and fairness of transactions, licensing of employees, protection of customer assets) and to promote the continued financial viability of the broker-dealer (that is, the SEC's net-capital rule). Although the System's examiner objectives are to ensure compliance with conditions of the Board's order, there may be instances where responsibilities will overlap, such as the evaluation of computer systems for computing SEC net-capital requirements and the ability to track positions and institute appropriate hedging transactions. Thus, examination staff are encouraged to contact SROs concerning areas of common interest (reviewing the underwriting subsidiary's latest examination letter from its examining SRO is standard procedure). Of course, federal banking law precludes System examiners from divulging confidential information to an SRO without Board approval.

2185.0.1 POWERS

The Board's original underwriting order was issued in April 1987 (see 1987 FRB 473). Underwriting was specifically permitted in—

1. municipal revenue bonds that are rated as investment quality (that is, in one of the top four categories) by a nationally recognized rating agency, except that industrial development bonds in these categories shall be limited to "public ownership" in industrial development bonds (that is, those tax-exempt bonds in which the issuer, or the governmental unit on behalf of which the bonds are issued, is the sole owner, for federal income tax purposes, of the financed facility (such as airports and mass commuting facilities));

2. mortgage-related securities (obligations secured by or representing an interest in one- to four-family residential real estate), rated as investment quality (that is, in one of the top four categories) by a nationally recognized rating agency; and

3. commercial paper that is exempt from the registration and prospectus requirements of the SEC pursuant to the Securities Act of 1933 and that is short term, of prime quality, and issued in denominations no smaller than $100,000.

A subsequent order (see 1987 FRB 731) expanded the underwriting subsidiary's ability to also underwrite—

4. consumer receivable–related securities that are rated investment quality.

These two 1987 orders will be referred to as the *1987 order* (see appendix B for the complete 1987 firewall conditions).

Although the Board authorized underwriting of the aforementioned types of securities in 1987, operations did not begin until the following year. In addition to delays caused by court challenges, the Competitive Equality Banking Act of 1987 placed a moratorium on underwriting activities. Finally, in June 1988, underwriting subsidiaries were able to commence ineligible securities activities after the Supreme Court refused to hear an appeal of a securities industry trade association.

Later in 1988, five bank holding companies filed applications to expand the authority of their section 20 subsidiaries to underwrite or deal in any type of debt (that is, corporate, sovereign, or municipal debt regardless of rating) and equity securities (except mutual funds). The Board approved those applications in January 1989 (the *1989 order*), but delayed the commencement of equity securities activities for at least one year. Moreover, the Board stipulated that the new security powers could not be exercised until notified by the Board that it has determined that the securities subsidiary has put in place the operational and managerial infrastructure necessary to ensure compliance with the operating limitations of the order.

2185.0.2 FIREWALLS

In reaching the conclusion that ineligible securities underwriting and dealing would not lead to significant adverse effects under section 4(c)(8) of the Bank Holding Company Act, the Board generally has relied upon a framework of prudential limitations that operate by addressing

practices, transactions, or relationships that have the potential for conflicts of interest, unsound banking practices, unfair competition, or other possible adverse effects. The basic approach of these limitations is to require ineligible securities activities to be conducted in a separate, strongly capitalized holding company subsidiary subject to firewalls intended to insulate affiliated banks from attendant risks. In general, the firewalls—

1. require that equity investments and loans to the underwriting subsidiary that qualify as regulatory capital not be counted toward the holding company's consolidated capital for regulatory purposes (the underwriting subsidiary's assets are also excluded);

2. prohibit credit extensions for the benefit of the underwriting subsidiary, including credit enhancements of securities and purchases of ineligible securities underwritten and dealt in by the subsidiary;

3. prohibit credit extensions to section 20 subsidiaries that have been authorized to underwrite and deal in any debt or equity security, and generally prohibit purchases and sales of financial assets from such subsidiaries (see the revisions effective January 7, 1997);

4. require separate offices for the underwriting subsidiary and limit employee, officer, and director interlocks and communication of confidential customer information between the underwriting subsidiary and affiliated banks; and

5. require disclosure that the underwriting subsidiary is separate from any affiliated banks and that securities offered, sold, or recommended are not FDIC insured.

As previously noted, there are certain differences between the Board's original firewalls adopted in 1987 and the latter ones adopted in 1989. The expanded range of activities permitted in 1989 present different risk characteristics leading to potentially greater price and credit risk (for example, securities activities are no longer limited to investment-grade securities). Accordingly, the firewalls were strengthened when the Board authorized five bank holding companies to engage in more extensive securities powers (see 75 FRB 192 (1989)). For example, the expanded firewalls prevent affiliated banks and thrifts from funding the operations of the section 20 subsidiary, and prevent the parent bank holding company from furnishing funds in a manner that would undermine its ability to serve as a source of strength to its banks. In addition, the Board has decided that an underwriting subsidiary must have the appropriate managerial and operational infrastructure in place, including 1989 firewalls, and requires Reserve Bank confirmation before authorizing companies to engage in expanded securities activities (see section 2185.0.5.2, ''Managerial and Operational Infrastructure''). Further, upon receiving Board authorization to engage in expanded debt and equity securities powers, all of an underwriting subsidiary's activities become subject to the 1989 firewalls.

Due in part to certain unique international considerations, the Board modified several of the firewalls for section 20 subsidiaries of foreign banks. These modifications are discussed in appendix C.

2185.0.3 EXPANDED POWERS

In October 1989, the Board authorized Bankers Trust New York Corporation's underwriting subsidiary to engage as agent in the private placement of all types of securities (that is, any debt or equity security), including providing related advisory services, and to buy and sell all types of securities on the order of investors as a *riskless principal* (BT order). In reaching its decision, the Board noted that it is now well established that placing new issues of securities with a limited number of purchasers in transactions that do not involve a public offering is not underwriting for purposes of the Glass-Steagall Act. The Board also noted that riskless principal transactions should be regarded as brokerage activities and not as underwriting or dealing in securities. Since brokerage activities represent *''eligible revenue,''* the Board concluded that revenue derived from both activities is to be classified as *eligible revenue* for purposes of complying with its gross revenue test. The Board also relied upon certain representations or imposed conditions, which are in appendix D.

2185.0.3.1 Private Placement

The private-placement market involves the placement of new issues of securities with a limited number of financially sophisticated institutions and individuals in a nonpublic offering. Securities that are privately placed are not subject to the registration requirements of the Securities Act of 1933. Most importantly, a financial intermediary in private-placement transactions, as defined by the Board, acts solely as an agent of the issuer in soliciting purchasers; it does not purchase the securities and attempt to resell

them. In approving private placement as an eligible securities activity, the Board relied upon certain representations and conditions that are in appendix D.

2185.0.3.2 Riskless-Principal Transactions

"Riskless principal" is the term used in the securities business to refer to a transaction in which a broker-dealer, after receiving an order to buy (or sell) a security from a customer, purchases (or sells) the security for its own account to offset a contemporaneous sale to (or purchase from) the customer. It is understood in the industry that riskless-principal transactions only occur in the secondary market, and section 20 subsidiaries are required to conduct their business accordingly. The Board approved the request to engage in riskless-principal transactions subject to the conditions in appendix D.

2185.0.4 INSPECTION OBJECTIVES

As previously noted, the general inspection objectives are to verify compliance with the Board's revenue test, ensure that the firewall conditions are in place and functioning properly, and assess the overall financial condition of the subsidiary and its impact on the consolidated organization. To accomplish these objectives, it will be necessary to—

1. determine whether the policies, practices, procedures, and internal controls are adequate and adhered to (including prohibitions against tie-in arrangements, see section 3500.0, "Tie-In Considerations of the BHC Act.")
2. determine whether EDP and accounting systems are adequate and effective;
3. ensure that the company is following existing procedures for approved underwriting and dealing in eligible securities;
4. evaluate the financial performance of the subsidiary and its business plan and assess the subsidiary's impact on the parent bank holding company;
5. evaluate management;
6. assess the scope, frequency, and adequacy of internal audit coverage; and
7. obtain corrective action when policies, practices, procedures, or internal controls are deficient or when violations of laws, regulations, or Board conditions have been noted.

2185.0.5 INSPECTION PROCEDURES

2185.0.5.1 Scope of Inspection Procedures

The following procedures are all-inclusive and intended to be used only selectively. These procedures are divided into four parts: (1) managerial and operational infrastructure review, (2) annual inspection, (3) review for compliance with the Board's various firewall conditions (including modifications pertaining to private-placement and riskless-principal transactions) to be used in conjunction with an infrastructure review or annual inspection, and (4) supplemental inspection procedures (to be used only to conduct random or targeted tests, particularly when the section 20 subsidiary has a poor compliance record or has not been subject to substantial audits).

At the initial inspection of a section 20 subsidiary, examiners will need to review all formal policies and operating procedures. In subsequent inspections, efforts can be directed towards reviewing amended policies and procedures. The same concept—performing an initial comprehensive inspection and then focusing on changes—applies in evaluating other key factors in a section 20 subsidiary (that is, management, internal controls, internal audit, and computer and accounting systems). Thus, to develop the scope of inspection, examiners need to consider past inspections; the compliance record; recent internal audits; and actual or pending changes in operations, systems, and management.

Full knowledge of all procedures is necessary to select the appropriate procedures for use in a given situation. However, each set of procedures need be used only to the extent applicable, if at all. As a general rule, the initial inspection of a section 20 subsidiary should utilize infrastructure review and firewall conditions procedures. Portions of these procedures may also need to be employed in subsequent inspections.

To illustrate applicability of the various procedures, consider a hypothetical dealer in bank-eligible securities gradually expanding its activities, by first operating under the 1987 order and later under the 1989 order.

Initial Inspection

- Infrastructure review procedures
- Firewall condition procedures (check only 1987 order conditions)

Subsequent Inspection

- Annual inspection procedures
- Supplemental inspection procedures (if warranted)

Authorization to Exercise 1989 Powers

- Infrastructure review procedures (concerning new types of securities)
- Firewall condition procedures (revised and expanded)
- Supplemental inspection procedures (if warranted)

2185.0.5.2 Managerial and Operational Infrastructure

2185.0.5.2.1 Introduction to Managerial and Operational Infrastructure

The Board's January 18, 1989, order approved applications by five bank holding companies to underwrite and deal in corporate and other debt and equity securities subject to 28 conditions. In addition to augmenting its 1987 firewall conditions, the Board established more stringent start-up standards. An applicant may not commence the new activities until notified that the Board has determined the securities subsidiary has put in place the operational and managerial infrastructure necessary to ensure compliance with the operating limitations of the order, including computer, audit, and accounting systems; internal risk-management controls; and other policies and procedures consistent with sound practices. The Board's decision to authorize commencement of corporate debt and/or equity underwriting activities is based on a report prepared by Federal Reserve examiners. This report describes examiners' findings from an on-site review of a section 20 company and its subsidiaries' operational and managerial infrastructure (infrastructure review). The infrastructure review procedures (subsection 2185.0.5.2.4) are designed to be used in determining whether such policies and procedures are in place.

2185.0.5.2.2 Inspection Personnel

The initial infrastructure reviews (conducted by the Federal Reserve Bank of New York) involved the use of examiners with varied backgrounds and specialties. Typically, inspection teams consisted of at least one specialist in audit and EDP systems, one senior holding company inspector, and a number of assistants. Utilization of an inspection team with varied expertise is recommended as a means to best address the breadth of topics to be evaluated.

2185.0.5.2.3 Special Considerations in Infrastructure Reviews

It is important to closely focus upon certain factors described below in which a section 20 subsidiary is operating under the 1987 order, and an infrastructure review is required to determine whether the dealer is prepared to exercise expanded powers under the 1989 order. As previously noted, concurrent with its approval of expanded securities activities for section 20 subsidiaries, the Board buttressed its firewall conditions. New requirements were placed upon credit relationships between nonbank affiliates and section 20 subsidiaries, and affiliated depositories are generally prohibited from engaging in the purchase or sale of financial assets with or extending credit to section 20 subsidiaries. Credit restrictions also encompass daylight overdrafts incidental to clearing securities transactions, except for U.S. or Canadian government or government-guaranteed securities. (See appendix A for conditions 1(b), 2, 21(a), 21(b), and 22.) Accordingly, the revised requirements may necessitate significant changes in existing intercompany relationships. Thus, for a section 20 subsidiary seeking to engage in 1989 powers, determine whether—

1. management has adopted changes in securities clearance arrangements to prevent daylight overdrafts on securities other than U.S. and Canadian government (and government-guaranteed) and agency securities (if dealer clears through or maintains accounts with affiliated depository institutions);

2. the section 20 subsidiary can quickly unwind existing repurchase agreements or other funding arrangements with affiliated depository institutions and is prepared to implement collateralized borrowing requirements with nonbank affiliates; and

3. prohibitions with respect to the purchase and sale of financial assets are in place.

2185.0.5.2.4 Infrastructure Review Procedures

2185.0.5.2.4.1 Management

The quality of management is a key factor to consider in evaluating a section 20 subsidiary with either 1987 or expanded securities powers. However, underwriting and dealing in all types of debt and equity securities involves direct participation in different securities markets from those previously engaged in by banks directly. Hence, management must be knowledgeable about credit risks, market functions, and syndicate and hedging techniques with respect to each targeted market and type of security.

Examiners should conduct meetings with senior management and review professional qualifications to determine whether management is qualified to direct and supervise expanded debt and equity securities activities. Unless management is knowledgeable and involved with day-to-day operations, a firm can be exposed to excessive risk by the action of a few individuals. Accordingly, management supervision of trading and sales personnel is essential.

Examiners should review customer complaint files (required by SRO rules) to determine whether there have been frequent allegations charging unfair or unethical sales practices. It is vital to determine the nature and resolution of complaints (for example, satisfactory explanation, cash settlement, arbitration), and examiners may need to discuss this aspect with the designated SRO.

2185.0.5.2.4.2 Self-Regulatory Organization Examination Results

Obtain from management a copy of the letter pertaining to the latest examination of the subsidiary by its designated self-regulatory organization (usually the NASD) to determine whether the underwriting subsidiary is operating in conformance with relevant securities laws and regulations, including the SEC's net-capital rule. Discuss any deficiencies with the designated SRO.

2185.0.5.2.4.3 Internal Controls

Review internal risk-management controls to confirm that appropriate controls are in place with respect to—

1. procedures to ensure compliance with Board conditions, including advice to affected personnel throughout the organization (see section 2185.0.5.4, ''Board orders and Conditions'');
2. written underwriting and trading position limits (by type of security, trader, groups of traders, and individual issues) and adequate risk-monitoring procedures;
3. syndicate procedures (that is, credit and bidding authorization, due-diligence, and securities registration requirements);
4. segregation of duties;
5. control over data entry;
6. hiring competent employees with well-defined duties; and
7. the Board's rules governing equity securities underwritten or dealt in by section 20 subsidiaries.

The Board's order provides guidance concerning definitional and other issues associated with underwriting and dealing in equity securities. Preferred stock is an equity security for purposes of the order. In contrast, debt securities are defined to include those that are convertible into equity securities if, on the date the convertible securities are issued, the conversion price is greater than 115 percent of the market price of the equity security into which the debt security is convertible.

Generally, a bank holding company is permitted to acquire up to 5 percent of the voting shares of a nonbank company. Thus, a section 20 company's dealer inventory must be aggregated with its affiliates' holdings of voting securities. However, the Board has authorized an exemption to facilitate underwriting. It is permissible to acquire greater than 5 percent of the voting shares of an issuer pursuant to a bona fide firm commitment underwriting, so long as those shares are disposed of within 30 days of their acquisition and during that time the shares are not voted.

2185.0.5.2.4.4 Computer and Accounting Systems

Review computer and accounting systems to determine whether the computer systems currently utilized have the capacity to process and account for expanded types of securities activities proposed.

1. If more than one EDP system is utilized to account for various types of securities, confirm that section 20 subsidiary procedures provide for effective integration of data and management reporting.

2. Confirm whether hypothetical transactions have been utilized to test the ability of the system to accept and account for new types of securities. Review documentation and meet with internal auditors to determine their level of involvement.

3. Review the latest letter concerning examination by the section 20 subsidiary's designated self-regulatory organization and/or contact the SRO concerning its evaluation of EDP and accounting systems.

4. Review Reserve Bank and internal audit's evaluation of existing EDP systems and outside service bureaus. Perform other standard EDP evaluation procedures as necessary.

5. Test ability of systems to accurately segregate and report eligible and ineligible revenue.

a. Utilize department blotters constituting ''records of original entry'' under SEC recordkeeping rules to select a number of ''settled'' transactions. It is recommended that examiners select at least one eligible security, and one of each type of ineligible security, (that is, municipal revenue bond, mortgage-related security, commercial paper, consumer receivable–related security, and pro forma transactions in corporate debt and equity).

b. Request that management furnish a complete set of documentation to trace these transactions from the trader's original ticket through posting to the appropriate general ledger account and inclusion in revenue reports detailing eligible and ineligible revenue. Determine management's criteria for slotting such revenue as eligible or ineligible and evaluate procedures for resolving questions. For example, the only eligible revenues that can be obtained from dealing in municipal revenue bonds are those derived from bonds issued for university, housing, or dormitory purposes, and, accordingly, the selection process should look for ''close calls.''

2185.0.5.2.5 Internal Audit

Evaluate the internal audit program, including the qualifications of audit personnel. The 1989 order specifies that audit systems must be ''in place'' in order for the Board to determine that a section 20 subsidiary may commence expanded securities activities. Accordingly, examiners should expect to see fairly detailed audit procedures for ensuring compliance with all of the Board's conditions and its revenue limitation. General programs showing plans or budgets to conduct future audits are *not* sufficient. Holding companies without fairly detailed audit programs should be advised that the Reserve Bank will be unable to make a favorable infrastructure finding.

Obtain the latest reviews by internal and external auditors to determine whether auditors consider the subsidiary's internal controls, recordkeeping, and accounting and computer systems to be adequate. Verify the status of correcting past deficiencies and verify whether internal audits are conducted at least annually.

1. Review audit programs and reports of the section 20 subsidiary conducted since the previous inspection.

2. Evaluate the adequacy of the audit program in light of the following factors:

a. checks for the integrity of the slotting and reporting of eligible and ineligible revenue and monitoring of the gross revenue test;

b. procedures for ensuring compliance with all Board conditions by auditing various units directly responsible for compliance (for example, compliance units, controllers, and computer systems and services);

c. procedures for ensuring compliance in functional audits of other organizational units that are affected, but not directly responsible for compliance (for example, commercial lending and trust activities);

d. with respect to expanded debt and equity security activities, the development of comprehensive audit programs that recognize the different nature of activities (for example, due-diligence responsibilities, disclosure and registration requirements, and SEC and NASD rules pertaining to corporate security syndicate practices); and

e. standard financial audit procedures for trading activities (for example, external pricing of securities).

2185.0.5.3 Annual Inspection Procedures

The following procedures are intended for use during the annual inspection of a section 20 subsidiary to evaluate compliance with the Board's firewall conditions and revenue limitation and to evaluate its financial condition. In order to determine which, if any, supplemental inspection procedures to utilize, examiners will need to evaluate the section 20 subsidiary's past compliance record and the quality and findings of the related internal audit function.

As a general rule, it will not be necessary to repeat procedures employed in an infrastructure

review. However, in certain instances, it may be necessary to utilize infrastructure review procedures to determine whether the current infrastructure can accommodate significant new activities authorized subsequent to completion of an infrastructure review, or to review changes that have occurred in the infrastructure.

2185.0.5.3.1 Management

Review the quality and effectiveness of management. Focus on changes in management since the previous inspection by evaluating professional qualifications of new management officials.

2185.0.5.3.2 SRO Examination Results

Obtain from management a copy of the letter pertaining to the latest examination of the subsidiary by its designated self-regulatory organization (usually the NASD) to determine whether the underwriting subsidiary is operating in conformance with relevant securities laws and regulations, including the SEC's net-capital rule. Discuss any deficiencies with the designated SRO.

2185.0.5.3.3 Internal Controls

Review internal controls, to the extent necessary, to confirm that effective controls are in place and adhered to. Ordinarily, a strong audit department will review and test existing controls, thus minimizing the need for examiners to engage in extensive internal-control testing.

The primary focus of an annual inspection should be to analyze and evaluate internal control modifications, if any, since the previous inspection. Changes may occur because of strategic business decisions or in response to regulatory requirements. In addition to following up on required changes associated with approved 4(c)(8) applications of the particular bank holding company, examiners need to consider general firewall modifications. In reviewing its firewalls, the Board has in certain instances authorized generic changes in permitted activities by order affecting all section 20 subsidiaries (for example, underwriting rated asset-backed securities of affiliates and treating Canadian government securities identically to U.S. government securities).

2185.0.5.3.4 Computer and Accounting Systems

Generally, only an in-depth review of the computer and accounting systems is necessary in the course of conducting an infrastructure review. However, there may be certain instances when authorization to engage in new activities (see above) requires subsequent scrutiny of the computer and accounting systems to verify compliance. For example, the Board requires that companies authorized to engage in riskless-principal transactions maintain specific records to code and identify all such transactions.

2185.0.5.3.5 Internal Audit

Obtain the latest reviews by internal and external auditors to determine whether auditors consider the subsidiary's internal controls, recordkeeping, and accounting and computer systems to be adequate. Verify the status of correcting past deficiencies and whether internal audits are conducted at least annually.

1. Review audit programs developed for activities authorized since the previous inspection.

2. Review audits conducted since the previous inspection. Specifically evaluate findings concerning—

a. slotting and reporting of eligible and ineligible revenue and monitoring of the gross revenue test (It is recommended that the revenue-reporting system be tested at each inspection if the internal audit function has not performed adequate tests (see section 2185.0.5.2.4.4)).

b. adoption and implementation of policies and procedures for ensuring compliance in organizational units that are affected, but not directly responsible for, compliance with Board conditions;

c. compliance with all Board conditions;

d. syndicate practices; and

e. standard financial audits of trading activities.

2185.0.5.3.6 Financial Performance

Evaluate operating results since the previous inspection and the overall financial condition of the subsidiary, and assess the impact on the parent bank holding company (see appendix A, condition 4).

2185.0.5.4 Board Orders and Conditions

The following procedures are designed to be used in determining whether a section 20 subsidiary is being operated in accordance with Board conditions, including conditions relating to private-placement transactions (section 2185.0.5.5) and riskless-principal transactions (section 2185.0.5.6). Applicable policies and procedures should be thoroughly evaluated during an initial inspection. Subsequent inspections should focus on modifications, if any, of policies and procedures. For the most part, emphasis is placed on determining whether policies and procedures have been implemented. After evaluating management, the compliance and internal audit functions, and previous compliance records, examiners can determine whether tests are required to determine adherence to written policies and procedures. Section 2185.0.5.7, ''Supplemental Inspection Procedures,'' includes suggestions for various sampling techniques that can be utilized for testing adherence to policies and procedures.

Procedures described below are designed to review compliance with the Board's various firewall conditions. Discussions of the Board's conditions, and subsequent modifications thereto, begin in appendix A.

2185.0.5.4.1 Types of Securities

1. Under the 1987 order, confirm that underwriting of ineligible securities is limited to the four specified types of securities.
2. Under the 1989 order, confirm that underwriting of ineligible securities is limited to the types permitted in a specific order or Board letter.

2185.0.5.4.2 Revenue Test

1. Compare reports required by Board order (condition 24)[1] to FR Y-20 and FOCUS reports and accounting records to determine whether the current and cumulative two-year ratio of bank-ineligible to total bank-eligible and bank-ineligible revenue is 25 percent or less.[2]

2. Confirm that unless specifically approved as a 4(c)(8) activity, any activity treated as a necessary incident to an ineligible securities activity (for example, private placement) is reported as ineligible revenue (see footnote 59 of the 1989 order).
3. Confirm that procedures manuals contain provisions for ongoing monitoring of this limitation.

2185.0.5.4.2.1 Interest Earned on Securities That a Member Bank Can Hold for Its Own Account

On September 11, 1996, the Board issued an order stating that it will no longer consider interest income earned on debt securities that a member bank could hold for its own account as revenue derived from underwriting and dealing in securities for purposes of the revenue test. This revised method for computing compliance with the revenue limitation is effective for reports filed for the third quarter of 1996. Subsequently, on October 30, 1996, the Board further conveyed its decision to allow any section 20 subsidiary that possesses the requisite data to use the amended treatment for the past eight calendar quarters. Examiners should confirm that such an accounting treatment and classification is being correctly applied.

2185.0.5.4.3 Capital Investment and Funding

1. Review the SEC FOCUS Report (condition 24) to determine the amount of equity and subordinated debt, if any, that qualifies as SEC capital (see FOCUS Part II, ''Computation of Net Capital'').

1.References to conditions in these inspection procedures refer to the 1989 Board order unless otherwise noted. For example, condition 4 of the 1987 order requires submission of reports. Also, see appendix A for a discussion of conditions that are not applicable to securities firms operating under the 1987 order.

2. The revenue test is a two-year rolling average with cumulative bank-ineligible revenue as the numerator and the cumulative total of bank-eligible and bank-ineligible revenue as the denominator. After the eighth quarter of bank-ineligible securities activities, the first quarter's bank-ineligible and total bank-eligible and bank-ineligible revenue are deleted from the numerator and denominator, respectively, and the ninth-quarter revenues are added. Comparable calculations are made at the end of each successive quarter. Current quarterly bank-ineligible revenue may exceed 25 percent of total bank-eligible and bank-ineligible revenue, provided that the cumulative two-year ratio remains within the limit. As of March 6, 1997, the Board's alternative indexed-revenue test was no longer available. Bank holding companies and their section 20 company subsidiaries that had elected the indexed-revenue test may rely on previously reported indexed revenues through the end of December 1998 in computing the two-year average.

2. Verify that the parent holding company has procedures in place and has made the required deductions from its consolidated capital and assets (condition 1(a)).

3. Review the section 20 subsidiary's general ledger to determine whether it reconciles with Federal Reserve Form FR Y-20.

4. Determine whether—

a. extensions of credit to the underwriting subsidiary provided by the parent bank holding company and nonbank subsidiaries are collateralized in accordance with the provisions of section 23A(c) of the Federal Reserve Act or deducted from consolidated capital (condition 1(b));

(Note: To be in compliance with the order, collateral must actually be pledged. An ''Agreement to Pledge'' is not sufficient.)

b. extensions of credit, including repurchase agreements, to securities subsidiaries (operating under the 1987 order) from an affiliated depository organization conform with section 23A and section 23B of the Federal Reserve Act, and that there are no extensions of credit from affiliated banks to 1989 subsidiaries (see appendix A discussion of condition 21 concerning exceptions for certain repos); and

c. securities clearance credit provided by affiliate banks and thrifts complies with Board condition 21(b).

5. If the Board conditioned its approval on the parent organization's raising capital, confirm that Board requirements were met.

6. If the Board authorization letter to commence activities limited the subsidiary to position size, etc., contained in the capital plan, confirm that subsidiary is conducting business accordingly.

2185.0.5.4.4 Credit to Customers of Underwriting Subsidiary

1. Confirm that the securities subsidiary's and affiliated depository institutions' procedures manuals discuss the prohibition against credit enhancements on ineligible securities (condition 5).

2. Confirm that procedures manuals for lending officers include adequate instructions concerning the prohibition against affiliates extending credit to customers secured by or to purchase securities underwritten or distributed by the section 20 subsidiary (condition 6).

3. Verify that procedures manuals require the maintenance of records to ensure that other credit to clients whose ineligible securities are underwritten or dealt in by the section 20 subsidiary is for a documented special purpose other than the payment of principal, interest, or dividends on such securities, and it is on an arm's-length basis (conditions 7 and 8).

4. Confirm that the subsidiary's thrift affiliates have implemented policies and procedures to observe restrictions of sections 23A and 23B of the Federal Reserve Act (condition 9).

5. Confirm that procedures manuals for lending officers include necessary procedures making the preceding five conditions applicable to parties that are major users of projects financed by industrial revenue bonds (condition 10).

6. Policies and procedures (subsidiary depositories):

a. confirm that the parent holding company has established policies and procedures at its subsidiary banks and thrifts governing their participation in financing transactions underwritten or arranged by the section 20 subsidiary (condition 11); and

b. ensure that the policies and procedures address appropriate limits on exposure and require an independent and thorough credit evaluation in connection with such participations.

7. Policies and procedures and limitations (consolidated basis):

a. confirm that the parent holding company has established policies, procedures, and limitations regarding exposure of the holding company on a consolidated basis to any single customer whose securities are underwritten or dealt in by the section 20 subsidiary (See also SR-89-5 and SR-89-23) (condition 12); and

b. ensure that the holding company has developed a system to monitor exposures to single customers on a consolidated basis.

2185.0.5.4.5 Requirement to Maintain Corporate Separateness (Condition 13)

1. Verify that the holding company's policies require that the underwriting subsidiary maintain separate offices from affiliated banks and thrifts and that there are no officer, director, or employee interlocks between the section 20 subsidiary and bank or thrift affiliates.

2. When meeting with the section 20 subsidiary's personnel, confirm that the subsidiary's offices are clearly distinguished from those of affiliated banks and thrifts.

2185.0.5.4.6 Disclosure Statement (Condition 14)

1. Confirm that procedures manuals include provisions requiring the forwarding of disclosure statements to customers.
2. Review a sample disclosure statement to ensure that all required information is disclosed.

2185.0.5.4.7 Marketing Activities on Behalf of an Underwriting Subsidiary (Condition 15)

1. Verify that the holding company has established policies stating that no section 20 subsidiary nor any affiliated bank or thrift will engage in advertising or enter into an agreement indicating that an affiliated bank or thrift is responsible in any way for the section 20 subsidiary's obligations.

Condition 16: Reserved

2185.0.5.4.8. Investment Advice by Bank/Thrift Affiliates (Conditions 17 & 18)

1. Confirm that the holding company has established policies requiring that a bank or thrift affiliate may not express an opinion regarding ineligible securities underwritten or dealt in by the section 20 subsidiary, unless the bank or thrift notifies the customer of the section 20 subsidiary's involvement with the securities.
2. Confirm that procedures have been developed governing fiduciary activities by affiliated banks, thrifts, or trust or investment advisory subsidiaries, whereby such entities are precluded from purchasing and the section 20 subsidiary is precluded from selling ineligible securities in which the section 20 subsidiary makes a market or is underwriting (and for 60 days after close of the underwriting period).

2185.0.5.4.9. Extensions of Credit and Purchases and Sales of Assets (Conditions 19–22)

1. Confirm that procedures have been developed prohibiting the applicant or any of its subsidiaries, other than the underwriting subsidiary, from purchasing, as principal, ineligible securities that are underwritten by the underwriting subsidiary during the period of the underwriting and for 60 days after the close of the underwriting period, or purchasing from the underwriting subsidiary any ineligible security in which the underwriting subsidiary makes a market.
2. Confirm, to the extent applicable, that procedures and recordkeeping requirements have been developed relating to the purchase and sale of ineligible securities between affiliates participating in simultaneous cross-border underwritings (such purchases or sales must be based on bona fide indications of interest from customers in the various markets).
3. Confirm that an underwriting subsidiary only underwrites or deals in ineligible securities issued by affiliates or representing assets originated by affiliates if—
   a. the securities are rated by a nonaffiliated nationally recognized rating organization; or
   b. the securities are issued or guaranteed by FannieMae, FHLMC, or GNMA, or represent interests in such obligations.
4. If the subsidiary operates pursuant to the 1989 order, confirm that policies and procedures have been developed to prohibit the applicant's bank or thrift affiliates from directly or indirectly extending credit in any manner to an affiliated underwriting subsidiary or a subsidiary thereof, or issuing a guarantee, acceptance, or letter of credit, including an endorsement or standby letter of credit, for the benefit of the underwriting subsidiary or a subsidiary thereof. This prohibition does not apply to an extension of credit by a bank or thrift to an underwriting subsidiary that is incidental to the provision of clearing services by the bank or thrift to the underwriting subsidiary with respect to securities of the United States or Canada or their agencies, or securities on which the principal and interest are fully guaranteed by the United States or Canada or their agencies, if the extension of credit is fully secured by such securities, is on market terms, and is repaid on the same calendar day. See condition 21(b) of the 1989 order, appendix A.
5. Confirm that policies and procedures have been developed to prohibit the purchase and sale of financial assets between the underwriting subsidiary and its affiliated banks and thrifts. This limitation shall not apply to the purchase and sale of assets that have a readily identifiable and publicly available market quotation and

that are purchased at that market quotation for purposes of section 23A of the Federal Reserve Act (12 U.S.C. 371c(d)(6)), provided those assets are not subject to a repurchase or reverse repurchase agreement between the underwriting subsidiary and its bank or thrift affiliate. This limitation also does not apply to the purchase and sale of U.S. Treasury securities or direct obligations of the Canadian federal government that are not subject to repurchase or reverse repurchase agreements between the underwriting subsidiary and its affiliated bank or thrift subsidiary, branch, or agency. If the section 20 subsidiary operates pursuant to the 1987 order, instead it must comply with sections 23A and 23B of the Federal Reserve Act.

6. If the section 20 subsidiary, operating pursuant to the 1989 order, has received permission to engage in certain purchase and sale transactions; repurchase agreements, swap, and option transactions; and futures commission merchant transactions with bank and thrift affiliates (see appendixes A and G), confirm that—

a. the sole purpose of the repurchase and reverse repurchase transactions is to accommodate the operational needs of a foreign affiliate and *not* to fund the section 20 subsidiary;

b. the sole purpose of the swaps and options transactions is to hedge the exposure of the section 20 subsidiary and not to fund it;

c. the section 20 subsidiary pledges U.S. securities to collateralize the risk exposure arising from the swap and option transactions (that is, daily mark-to-market required);

d. the repurchase and reverse repurchase, transactions are secured in accordance with section 23A of the Federal Reserve Act;

e. the repurchase, reverse repurchase, and swap and options transactions are conducted at arm's length and do not invoke preferential terms or conditions in accordance with section 23B of the Federal Reserve Act;

f. if an affiliated futures commission merchant matches offsetting futures transactions with affiliates, the section 20 subsidiary marks to market daily and posts collateral (see appendix G); and

g. the parent holding company has provided the bank affiliate with a written guarantee indemnifying the bank against any losses arising from the section 20 subsidiary's nonperformance.

7. Request that management document and describe how the purpose of the transactions described in procedure 6 above complies with Board requirements.

8. Request documentation demonstrating that risk exposure on swaps and options transactions is collateralized as required.

2185.0.5.4.10 Exchange of Confidential Customer Information

1. Confirm that procedures manuals require a customer's consent for the exchange of confidential customer information between the section 20 subsidiary and bank or thrift affiliates (condition 23).

2185.0.5.4.11 Transfer and Modification of Activities (Condition 25)

1. Review directors' minutes to ensure that section 20 activities previously authorized and conducted by the subsidiary have not been transferred to other affiliates without prior notification to and review by the Board.

2185.0.5.4.12 Limitations on Reciprocal Arrangements and Discriminatory Treatment (Conditions 26 & 27)

1. Confirm that the parent holding company has established policies and procedures affirming that neither it nor any of its subsidiaries will, directly or indirectly, enter into any reciprocal arrangements, under which the holding company would agree with another holding company to enter into transactions with each other for the purpose of evading any of the Board's requirements on securities activities or any other prohibitions on transactions between affiliates of banks.

2. Confirm that the parent holding company has established policies and procedures at its bank and thrift subsidiaries requiring that these subsidiaries will not extend or deny credit or services or vary the terms or conditions thereof, if the effect is to treat unaffiliated securities firms less favorably than their affiliated section 20 subsidiary (unless the action is based on objective criteria or is consistent with sound business practices) or if the intent is to create a competitive advantage for the affiliated section 20 subsidiary.

2185.0.5.5 Private Placements
(See appendix D for conditions)

1. Confirm that the section 20 subsidiary maintains specific records of its private placements and review them to further confirm that those records specifically identify those placement transactions in which credit or other financing is provided concurrently by a depository affiliate(s).

2. Review policies and procedures to confirm that the section 20 subsidiary—

a. will not privately place securities that are registered under the Securities Act of 1933;

b. will not purchase or repurchase for its own account the securities being placed (even as riskless principal) or inventory unsold portions of issues of these securities; and

c. will place securities only with a limited number of investors, based on regulations promulgated pursuant to the Securities Act of 1933.

3. If the holding company has received specific permission for the parent and its nonbank subsidiaries to purchase securities privately placed by the section 20 subsidiary, confirm that—

a. the parent has established appropriate internal policies, procedures, and limitations regarding the amount of securities of any particular issues placed that may be purchased by the parent and each of its nonbanking subsidiaries, individually and in the aggregate;

b. limitations referred to in 3a. above are incorporated into the condition 12 consolidated exposure limit to any single customer; and

c. the aggregate purchase limit in 3a. above is less than 50 percent of the issue being placed.

4. If the holding company has received permission for its affiliates to extend credit to an issuer to repay the principal amount of securities privately placed by the section 20 subsidiary, confirm that the holding company has caused lending affiliates to adopt policies and procedures requiring that at least three years elapse between the time of private placement and the extension of credit.

NOTE: (Pursuant to section 4(c)(1) of the Bank Holding Company Act, a section 20 subsidiary may privately place unrated securities of affiliates with sophisticated institutions.)

2185.0.5.6 Riskless-Principal Transactions

1. Verify whether the company is authorized to engage in riskless-principal transactions only in the secondary market and, if so, verify that its policies and procedures—

a. prohibit the section 20 subsidiary from engaging in riskless-principal bank-ineligible securities transactions if the customer is the issuer of securities to be sold or if the customer is selling bank-ineligible securities in any transaction in which the company has a contractual commitment to place securities as agent of the issuer;

b. prohibit the section 20 subsidiary from acting as riskless prinicipal in any transaction involving a bank-ineligible security for which the bank holding company or any of its affiliates acts as an underwriter (during the period of the underwriting or for 30 days thereafter) or dealer; and

c. prohibit the section 20 subsidiary from entering quotes for specific bank-ineligible securities in the NASDAQ or any other dealer quotation system in connection with riskless-principal transactions.[2a]

2. Verify that a section 20 subsidiary authorized to engage in riskless-principal transactions maintains specific records to code and identify all riskless-principal transactions.

3. Use sample transactions testing to confirm that practices conform with stated policies by—

a. selecting sample transactions at random from specific records of riskless-principal transactions;

b. requesting original order tickets; and

c. comparing the time of offsetting purchases and sales of riskless-principal transactions.

NOTE: A critical factor in identifying riskless-principal transactions is the time at which the order is received and the time at which the order is executed through offsetting purchases and sales as principal. Although several hours (but not more than one day) may elapse between receipt and execution of an order, execution of offsetting purchases and sales should occur almost simultaneously. SEC recordkeeping rules require that an order be time stamped both upon receipt and execution. For additional information, see the supplemental inspection procedures.

2a. The company or its affiliates may enter bid or ask quotations, or publish ''offering wanted'' or ''bid wanted'' notices on trading systems other than NASDAQ or an exchange, if the company or its affiliate does not enter price quotations on different sides of the market for a particular security for any two-day period.

NOTE: Procedure 3 above should be followed at each inspection of a dealer authorized to engage in riskless-principal transactions if the internal audit function has not performed adequate tests.

2185.0.5.7 Supplemental Inspection Procedures

The following procedures are recommended for use in testing for conformance with formal operating procedures. Ordinarily, it is expected that only some of the procedures will be utilized to conduct random or targeted tests. However, these supplemental procedures should be used more extensively when the section 20 subsidiary has a poor compliance record or has not been subject to substantial audits. Procedures are referenced to the Board's 1989 conditions (see appendix A for a listing and discussion of conditions).

2185.0.5.7.1 Condition 5

1. Obtain a listing of recent securities issues underwritten and distributed by the section 20 subsidiary.
2. On a sampling basis, review prospectuses or official statements or publications from check rating services on these issues to verify that no affiliate issued a letter of credit or any other device or facility used to enhance the creditworthiness or marketability of the issues.

2185.0.5.7.2 Condition 6

1. Obtain a listing of securities underwritten by and in which the section 20 subsidiary makes a market.
2. Review collateral ledgers in affiliated state member banks to determine whether loans are made against securities described above. If so, investigate circumstances to determine whether the bank knowingly extended credit.

2185.0.5.7.3 Condition 7

1. Review the section 20 credit files of companies served to determine whether any funds to repay principal or interest on securities are being advanced by affiliates. (See commercial paper discussion in appendix A.)
2. If appropriate, follow up in state member bank credit departments or consult with the appropriate regulator in other instances.

2185.0.5.7.4 Condition 10

1. Identify industrial revenue bonds that may have been underwritten, and using transactions sampling, verify that procedures have been followed.

2185.0.5.7.5 Condition 13

1. Obtain listings of directors and officers of the section 20 subsidiary and verify that they do not hold positions with affiliated banks and thrifts.

2185.0.5.7.6 Conditions 15 & 16

1. Obtain access to advertising files required to be maintained by the section 20 subsidiary under securities regulations.
2. Utilize sampling techniques to check advertising materials to confirm that the policies are adhered to.
3. Review service agreements with affiliates to verify that depositories are not authorized to engage in impermissible marketing activities.
4. Consult with bank and thrift examiners to confirm that there is no evidence of impermissible marketing activities by affiliated depositories.

2185.0.5.7.7 Conditions 17 & 18

1. Obtain copies of documentation to confirm compliance with disclosure requirements (for example, one-time disclosures or advisory literature with disclosure statements).
2. Review the section 20 subsidiary's purchase and sale blotters (constituting SEC "records of original entry") to determine whether bank, thrift, or trust or investment advisory affiliates have purchased ineligible securities underwritten or dealt in by the subsidiary. If so, refer to Federal Reserve trust examiners to make appropriate inquiries directly, or through other supervisory agencies, to determine whether such purchases were in the investment discretion of the affiliate, and, if so, whether they are specifically authorized by the account holder or trust instrument.

2185.0.5.7.8 Conditions 19, 20, 21(a), and 22

1. Obtain a listing of recent underwritings in which the section 20 subsidiary participated and review purchase and sales blotters (records of original entry identifying the counterparty for purposes of SEC recordkeeping rules) to—

a. verify that impermissible sales were not made to affiliates;

b. investigate and research (for example, review a sampling of offering circulars) the originator of underlying assets collateralizing asset-backed securities underwritten and dealt in to confirm that securities of affiliates are rated or otherwise conform to the requirements of condition 20 (as revised in September 1989; see appendix A);

c. confirm that no affiliated insured depository institution has provided credit to finance an underwriting; and

d. confirm that no impermissible purchase and sale of assets has occurred with an affiliated bank or thrift.

2185.0.5.7.9 Condition 23

1. Review copies of consent forms to determine that consent has been obtained.

2185.0.5.7.10 Private Placements

1. Use sample transactions testing to confirm that the section 20 subsidiary does *not*—

a. privately place securities registered under the Securities Act of 1933;

b. take positions in securities it places (review purchase and sales blotters or confirmations); and

c. that neither it nor any of its affiliates extend credit to the issuer of securities on substantially the same terms as the securities being placed.

2. If a bank holding company has authority for the parent or nonbank subsidiaries to purchase securities privately placed by a section 20 affiliate, use sampling techniques to confirm that—

a. aggregate purchases of such securities are less than 50 percent of an issue being placed; and

b. aggregate holdings of such securities are in conformance with condition 12 limits established by the consolidated organization with respect to the issuer.

2185.0.5.7.11 Riskless-Principal Transactions

1. Compare specific records of riskless-principal transactions to records of securities privately placed, underwritten, or dealt in to test for conformance with Board conditions (that is, does the dealer conduct impermissible riskless-principal transactions in securities it underwrites, places, or deals in?).

2. Apply the testing procedures described under section 2185.0.5.6, ''Riskless-Principal Transactions.''

2185.0.6 CONCLUDING PROCEDURES

1. Prepare report comments and include them on the Other Matters report page concerning—

a. the overall financial performance of the subsidiary;

b. the quality of subsidiary management;

c. the adequacy of procedures established, including the internal audit function, to ensure compliance with Board conditions;

d. the adequacy of policies, practices, and procedures for engaging in securities activities;

e. violations of law or regulation;

f. internal control deficiencies;

g. apparent or potential conflicts of interest not addressed by firewall conditions; and

h. other matters of significance.

2. Significant weaknesses or deficiencies warrant specific comments on the Examiner's Comments page of the Inspection Report.

3. Update workpapers with any information that will facilitate future inspections.

4. When it is necessary, prepare a separate section 20 subsidiary inspection report for foreign banking organizations. Although foreign banks are treated as bank holding companies pursuant to section 4(c)(8), not all foreign banks are subject to holding company inspections.

APPENDIXES

Appendix A	1989 Section 20 Subsidiary Board Conditions
Appendix B	1987 Board Conditions
Appendix C	Firewall Conditions Applicable to Foreign Bank Subsidiaries
Appendix D	Board Conditions for Private-Placement and Riskless-Principal Transactions

2185.0.7 APPENDIX A—1989 SECTION 20 SUBSIDIARY BOARD CONDITIONS

A presentation of the Board's conditions in its January 18, 1989, order (1989 FRB 192) (1989 order), follows. Subsequent modifications to conditions are noted. In many instances, Board letters approving commencement of the 1989 powers will refer to commitment modifications granted in prior public Board letters. Accordingly, appendix G contains certain letters in which the Board has granted relief from commitments (and frequently imposed additional conditions). The following also notes 1989 conditions that are *not* applicable to an underwriting subsidiary operating under the 1987 order. This is vital information since a company operating under the 1987 order need only comply with the less restrictive 1987 firewall conditions. (The 1987 firewall conditions are in appendix B.) Finally, the wording of certain 1987 and 1989 conditions may vary slightly, but the intent is unchanged unless otherwise noted. The following listing of conditions reflects modifications made for *domestic banking organizations through January 1992.* For firewalls applicable to section 20 subsidiaries of foreign banking organizations, see appendix C.

Capital Adequacy Conditions

Condition 1(a). In determining compliance with the Board's capital adequacy guidelines, each applicant is required to deduct from its consolidated capital any investment it makes in the underwriting subsidiary that is treated as capital in the underwriting subsidiary. In accordance with the risk-based component of the Board's the capital guidelines, the applicant must deduct 50 percent of the amount of any investment in the underwriting subsidiary from tier 1 capital and 50 percent from tier 2 capital. If the amount deductible from tier 2 capital exceeds actual tier 2 capital, the excess would be deducted from tier 1 capital. In calculating risk-based capital ratios, the applicant should also exclude the underwriting subsidiary's assets from the holding company's consolidated assets.

Condition 1(b). The applicant shall also deduct from its regulatory capital any credit it or a nonbank subsidiary extends directly or indirectly to the underwriting subsidiary unless the extension of credit is fully secured by U.S. Treasury securities or other marketable securities, and it is collateralized in the same manner and to the same extent as would be required under section 23A(c) of the Federal Reserve Act if the extension of credit were made by a member bank.[3] In the case of the risk-based component of the Board's capital guidelines, the deductions for unsecured or not fully secured or inadequately collateralized loans shall be taken 50 percent from tier 1 and 50 percent from tier 2 as described above. Notwithstanding these adjustments, the applicant should continue to maintain adequate capital on a fully consolidated basis.

Comments:

A. This condition is intended to ensure that the holding company maintains a strong capital position to support its subsidiary banks and that the resources needed for that support would not be put at risk to fund the expanded securities activities. Thus, investments in underwriting subsidiaries are deducted from consolidated capital. In authorizing expansion of section 20 subsidiaries, the Board, in 1989, to further ensure the holding company's ability to serve as a source of strength, required that any loans to the securities subsidiary also be deducted from consolidated capital unless collateralized in accordance with section 23A(c).

B. The substance of condition 1(a) was present in both the 1987 and 1989 orders, although the treatment of subordinated debt that qualifies as SEC regulatory capital was clarified in the latter order. In addition, the Board used the 1989 order to discuss the treatment of section 20 subsidiary capitalization under the risk-based capital framework.

C. In approving capital and funding plans submitted pursuant to its 1989 order, the Board has granted standby authority for certain bank holding companies to extend additional unsecured credit in specified amounts to their section 20 subsidiaries. Where such authority is received, the total authorized line of credit must

3. An extension of credit means any loan, guarantee, or other form of credit exposure, including those described in condition 5.

be deducted from consolidated capital in evaluating regulatory capital—regardless of whether the line has been drawn upon.

D. Condition 1(b) is *not* applicable to companies operating under the 1987 order.

E. The Board has determined that certificates of deposit and banker's acceptances, including such instruments issued by or accepted by an affiliate bank, may be used to collateralize extensions of credit from the parent in amounts equal to 100 percent of the value of the loans. (See letter to J.P. Morgan Securities, Inc., dated June 19, 1989).

Condition 2. Reserved

Condition 3. Before commencing the new activities, each applicant must submit to the Board acceptable plans to raise additional capital as required by this order or demonstrate that it is strongly capitalized and will remain so after making the capital adjustments authorized or required by this order. An applicant may not commence the proposed activities until it has received a Board determination that the capital plan satisfies the requirements of this order and has raised the additional capital required under the plan.

Comment:

This condition was added in the 1989 order. Subsequent to the 1989 order, the Board will consider capital plans during the application process.

Condition 4. The underwriting subsidiary shall at all times maintain capital adequate to support its activity and cover reasonably expected expenses and losses in accordance with industry norms.

Comment:

To date, capital adequacy has been considered in processing applications or reviewing capital plans. If the section 20 subsidiary is profitable or experiencing modest losses, the examiner's *initial* on-site role is limited to verifying that the firm's activities are being conducted in accordance with the approved capital plan (condition 3). However, in certain instances, the Board has attempted to ensure capital adequacy by linking its approval to a requirement that a section 20 subsidiary's activities cannot exceed the type and level of business projected in the capital plan. Thus, it may be necessary to consult with Reserve Bank applications staff for purposes of ascertaining limitations on a firm's balance-sheet footings or type of business and to determine whether additional capital is required. When a significant time has elapsed after the approval process, examiners should consult with applications staff concerning whether current capital levels satisfy this requirement.

Credit Extensions to Customers of the Underwriting Subsidiary[4]

Condition 5. No applicant or subsidiary shall directly or indirectly extend credit, issue or enter into a stand-by letter of credit, asset purchase agreement, indemnity, guarantee, insurance or other facility that might be viewed as enhancing the creditworthiness or marketability of an ineligible securities issue underwritten or distributed by the underwriting subsidiary.

Comment:

This condition is intended to prevent transfer of risk to the banking system from securities activities of affiliates and the potentially less-than-objective credit practices that may result from the inherent conflicts of interest when an institution acts as both a supplier of credit and a seller of securities, as well as from unfair competition. The Board stated that any financial backing for securities that is necessary should come from unaffiliated lenders.

Condition 6. No applicant or subsidiary (other than the underwriting subsidiary) shall knowingly extend credit to a customer directly or indirectly secured by, or for the purpose of purchasing, any ineligible security that an affiliated underwriting subsidiary underwrites during the period of the underwriting or for 30 days thereafter, or to purchase from the underwriting subsidiary any ineligible security in which the underwriting subsidiary makes a market. This limitation extends to all customers of the applicant and its subsidiaries, including broker-

4. Unless otherwise stated, these conditions shall apply to a subsidiary of a bank or thrift institution to the same extent as they apply to the bank or thrift institution.

dealers and unaffiliated banks, but does not include lending to a broker-dealer for the purchase of securities when an affiliated bank is the clearing bank for such broker-dealer.

Comments:

A. This condition is designed to eliminate conflicts of interest by precluding affiliates from making loans to facilitate the purchase of securities underwritten by or in which the section 20 subsidiary makes a market.

B. Questions may arise as to what constitutes making a market in securities. Such a determination must be based on the facts, but it is important to note that a dealer is *not* presumed to make a market in every security it holds or sells. For example, the fact that a managing underwriter has a ''moral obligation'' to furnish a bid to repurchase securities it previously underwrote does not make it a market maker. If the dealer buys bonds it had underwritten two years prior and then resells them to customers or other dealers, that alone would not constitute market making. In contrast, regularly furnishing both bid and offer quotations would be indicative of making a two-sided market, that is, market making. Advertising or otherwise holding oneself out as a dealer in a particular class of securities (for example, governments, municipals, or equities) would also be indicative of market-making status.

Condition 7. No applicant or any of its subsidiaries may, directly or indirectly, extend credit to issuers of the ineligible securities underwritten by an affiliated underwriting subsidiary for the purpose of the payment of principal, interest, or dividends on such securities. To ensure compliance with the foregoing, any credit lines extended to an issuer by any bank holding company or any subsidiary shall provide for substantially different timing, terms, conditions, and maturities from the ineligible securities being underwritten. It would be clear, for example, that a credit has substantially different terms and timing if it is for a documented special purpose (other than the payment of principal, interest, or dividends) or there is substantial participation by other lenders.

Condition 8. Each applicant shall adopt appropriate procedures, including maintenance of necessary documentary records, to ensure that any extension of credit by it or any of its subsidiaries to issuers of ineligible securities underwritten or dealt in by an underwriting subsidiary are on an arm's-length basis for purposes other than payment of principal, interest, or dividends on the issuer's ineligible securities being underwritten or dealt in by the underwriting subsidiary. An extension of credit is considered to be on an arm's-length basis if the terms and conditions are substantially the same as those prevailing at the time for comparable transactions with issuers whose securities are not underwritten or dealt in by the underwriting subsidiary.

Comments:

A. These conditions are designed to complement other credit enhancement prohibitions, such as that contained in condition 5, and at the same time permit other usual and regular banking relationships.

B. If a section 20 subsidiary proposes to underwrite or deal in securities for an issuer who has an existing extension of credit, such as a committed facility, from the bank holding company or its subsidiaries which would permit the issuer to use the proceeds of the loan to repay such securities, the section 20 subsidiary should not underwrite such an issue unless—

(1) the issuer provides a representation that any borrowing from an affiliated entity under that facility will not be used to repay principal, dividends, or interest on securities underwritten by the section 20 affiliate; or

(2) the affiliated lender assigns or participates out a large portion of its lending commitment to unaffiliated entities, so that there is substantial participation by other lenders.

The use of multiple dealers and the fungible nature of money involved in many commercial paper programs to obtain funds for ''general corporate purposes'' raises serious questions as to the bona fides of an issuer's representations regarding use of proceeds. For example, if a commercial paper issuer has more than one commercial paper dealer and has lines from nonaffiliated banks in an amount sufficient to repay paper sold by the affiliated section 20 subsidiary, credit lines from an affiliated bank can be used to repay paper sold by other dealers but may not be used to repay paper sold by the bank. At the time the credit is drawn down, the banking affiliate's credit administrators must confirm with the section 20 subsidiary that the commercial paper sold by the section 20 affiliate is being ''rolled over'' (not redeemed) and that the proceeds of the loan are not being used to repay paper sold by the section 20 affiliate.

Condition 9. In any transaction involving an underwriting subsidiary, the applicants' thrift subsidiaries shall observe the limitations of sections 23A and 23B of the Federal Reserve Act as if the thrifts were banks.

Comment:

All thrift transactions with affiliates are now subject to the restrictions imposed by section 23A and 23B of the Federal Reserve Act.

Condition 10. The requirements relating to credit extensions to issuers noted in paragraphs 5–9 above shall also apply to extensions of credit to parties that are major users of projects that are financed by industrial revenue bonds.

Comments:

A. This condition is intended to avoid conflicts of interest and prevent the transfer of risk to the banking system.

B. A "major user" of a project would, for example, be a business that is individually responsible for 50 percent or more of the lease payments on a project financed with industrial revenue bonds.

Condition 11. Applicants shall cause their subsidiary banks and thrifts to adopt policies and procedures, including appropriate limits on exposure, to govern their participation in financing transactions underwritten or arranged by an underwriting subsidiary as set forth in this order. The Reserve Banks shall ensure that these policies and procedures are in place at the applicants' subsidiary banks and thrifts and applicants shall ensure that loan documentation is available for review by Reserve Banks to ensure that an independent and thorough credit evaluation has been undertaken in connection with bank or thrift participation in such financing packages, and that such lending complies with the requirements of this order and section 23B of the Federal Reserve Act.

Condition 12. Applicants should also establish appropriate policies, procedures, and limitations regarding exposure of the holding company on a consolidated basis to any single customer whose securities are underwritten or dealt in by the underwriting subsidiary.

Comment:

Conditions 11 and 12 above were added in January 1989 to specifically address concerns about a banking organization's multiple levels of involvement in leveraged transactions. The System's subsequent adoption of examination guidelines for highly leveraged transactions (SR-89-5 dated February 16, 1989) has the practical effect of extending conditions 11 and 12 to all holding companies and their underwriting subsidiaries, if any. (See also SR-89-23 dated October 25, 1989).

Limitations to Maintain Separateness of an Underwriting Affiliate's Activity

Condition 13. Directors, officers, or employees of a bank or thrift shall not serve as a majority of the board of directors or the chief executive officer of an affiliated section 20 subsidiary, and directors, officers, or employees of a section 20 subsidiary shall not serve as a majority of the board of directors or the chief executive officer of an affiliated bank or thrift.[5] The underwriting subsidiary will have separate offices from any affiliated bank or thrift.[6]

Disclosure by the Underwriting Subsidiary

Condition 14. An underwriting subsidiary will provide each of its customers with a special disclosure statement describing the difference between the underwriting subsidiary and its bank and thrift affiliates, pointing out that an affiliated bank or thrift could be a lender to an issuer, and referring the customer to the disclosure documents for details. In addition, the statement shall state that securities sold, offered, or

5. With specific authority from the Board, directors of subsidiary banks may serve as directors of the section 20 subsidiary under certain limited conditions. By orders dated July 10, 1990 (1990 FRB 756) and September 23, 1991 (1991 FRB 954), the Board permitted two directors of subsidiary banks to serve as directors of the section 20 subsidiaries where they would be less than a majority of the directors of the section 20 subsidiary. These directors were not officers of the affiliated banks, nor did they have authority to conduct the day-to-day business of the banks or handle individual bank transactions. No officers of the section 20 subsidiaries were employed by the banks.

6. An underwriting subsidiary may have offices in the same building as a bank or thrift affiliate if the underwriting subsidiary's offices are clearly distinguished from those of the bank or thrift affiliate.

recommended by the underwriting subsidiary are not deposits, are not insured by the Federal Deposit Insurance Corporation, are not guaranteed by an affiliated bank or thrift, and are not otherwise an obligation or responsibility of such a bank or thrift (unless such is the case). The underwriting subsidiary should also disclose any material lending relationship between the issuer and a bank or lending affiliate of the underwriting subsidiary as required under the securities laws and in every case whether the proceeds of the issue will be used to repay outstanding indebtedness to affiliates.

Comments:

A. Although the 1987 order did not specifically require disclosure that securities sold, offered, or recommended by the securities subsidiary are not insured deposits, it was implicit. All disclosure statements should contain an appropriate disclaimer.

B. With respect to disclosure of any material lending relationship, securities law requires that prospectuses and official statements disclose material lending relationships between issuers and lending affiliates. It is acceptable to make a blanket disclosure to customers advising them to read prospectuses and offering circulars with respect to specific securities issues.

Marketing Activities on Behalf of an Underwriting Subsidiary

Condition 15. No underwriting subsidiary nor any affiliated bank or thrift institution will engage in advertising or enter into an agreement stating or suggesting that an affiliated bank or thrift is responsible in any way for the underwriting subsidiary's obligations as required under section 23B of the Federal Reserve Act.

Comment:

Although a section 20 firm may use the same corporate logo or a name similar to that of a banking affiliate, condition 15 is intended to ensure corporate separateness of the section 20 subsidiary and to reduce customer confusion. A principal concern is to avoid giving the impression that section 20 investment products are obligations of an affiliate bank or are FDIC insured (unless they are). For example, it would be inappropriate for a section 20 representative to meet a retail deposit customer in a bank branch manager's office to discuss the sale of securities.

Condition 16. Reserved

Investment Advice by Bank/Thrift Affiliates

Condition 17. An affiliated bank or thrift institution may not express an opinion on the value or the advisability of the purchase or the sale of ineligible securities underwritten or dealt in by an affiliated underwriting subsidiary unless the bank or thrift notifies the customer that the underwriting subsidiary is underwriting, making a market, distributing, or dealing in the security.

Comments:

A. To mitigate conflicts of interest, an affiliated bank or thrift must notify the customer if it makes recommendations concerning securities underwritten by, dealt in, or in which the section 20 subsidiary makes a market. It is acceptable to make a one-time blanket disclosure advising that recommendations may include ineligible securities underwritten or dealt in by an affiliate.

B. Bank officer bonuses may be based partially upon ''soft-dollar credits'' generated, for example, from introducing issuer or retail and institutional clients to the section 20 firm. It would, however, be contrary to the intent of the firewalls, as well as the interagency policy statement on the retail sales of nondeposit investments products, for bank personnel to be compensated directly based upon the number of transactions or dollar volume of transactions introduced to the section 20 firm.

Condition 18. No applicant nor any of its bank, thrift, or trust or investment advisory subsidiaries shall purchase, as a trustee or in any other fiduciary capacity, for accounts over which they have investment discretion, ineligible securities (a) underwritten by the underwriting subsidiary as lead underwriter or syndicate member during the period of any underwriting or selling syndicate, and for a period of 60 days after the termination thereof, and (b) from the underwriting subsidiary if it makes a market in that security, unless in either case, such purchase is specifically authorized under the instrument creating the fiduciary relationship, by court order, or by the law of the jurisdiction under which the trust is administered.

Comment:

This condition is a restatement of general principles of fiduciary law that prohibit self-dealing. It is intended to prevent conflicts of interest by precluding affiliated fiduciaries from backstopping or otherwise supporting the operations of an underwriting affiliate. State law governs many fiduciary relationships and practices. If an account is governed by a state law that permits trust customers to purchase securities from affiliated dealers, a Section 20 firm is not precluded from selling securities to such customers. If there are any questions, consult the trust examiners.

Extensions of Credit and Purchases and Sales of Assets

Condition 19. No applicant nor any of its subsidiaries, other than the underwriting subsidiary, shall purchase, as principal, ineligible securities that are underwritten by the underwriting subsidiary during the period of the underwriting and for 60 days after the close of the underwriting period, nor shall any applicant purchase from the underwriting subsidiary any ineligible security in which the underwriting subsidiary makes a market.

Comments:

A. Conditions 19, 21, and 22 are intended to ensure that the risk arising from the activities of a section 20 subsidiary is not shifted directly to an insured institution protected by the federal safety net. These conditions also control funding and prevent the perception that a bank-affiliated company has an unfair competitive advantage over securities companies that are not bank affiliated.

B. In an order dated January 4, 1990 (1990 FRB 158), the Board modified condition 19 to permit the purchase or sale of ineligible securities between any section 20 subsidiary and its affiliates involved in cross-border underwritings:

"... in the case of ineligible securities that are being issued in a simultaneous cross-border underwriting in which the underwriting subsidiary and a foreign affiliate or affiliates are participating, such securities may be purchased or sold pursuant to an intersyndicate agreement for the period of the underwriting where the purchase or sale results from *bona fide* indications of interest from customers. Such purchases or sales shall not be made for the purpose of providing liquidity or capital support to the underwriting subsidiary or otherwise to evade the requirements of this Order. An underwriting subsidiary shall maintain documentation on such transactions."

C. In certain instances when a section 20 firm is an underwriter of ineligible securities, its affiliates may purchase syndicate securities directly from another syndicate member. Section 23B of the Federal Reserve Act permits such a purchase of securities by a bank when an affiliate of that bank is a principal underwriter of the securities, provided that the purchase is approved, before such securities are initially offered for sale to the public, by a majority of non-officer-employee directors of the bank or any affiliate of the bank. In lieu of considering each purchase individually, non-officer-employee directors can establish prospective purchase standards. Outside directors are required periodically to review purchases made pursuant to prospective purchase standards to ensure that they have been followed, as well as the standards themselves to ensure that they continue to be appropriate in light of market and other conditions. These section 23B securities purchase procedures have been deemed acceptable for use by any affiliate of the section 20 firm; however, if purchases are made under these procedures, examiners will need to review directors minutes to verify prior authorization for such purchases.

D. Questions may arise concerning instances in which a section 20 firm is not a syndicate member, but is a member of a selling group (i.e., signed the selected dealer agreement in order to distribute new issue securities). Selling group members are part of the underwriting or distribution process and, therefore, all of the underwriting firewalls apply with respect to ineligible securities sold pursuant to a selected dealer agreement.

However, there is no guarantee that a selling group member will receive an allocation of securities. Accordingly, if *no securities are allocated* to the affiliated section 20 firm, the underwriting firewalls (for example, purchase of ineligible securities from the underwriter) do not apply with respect to that issue of ineligible securities.

Condition 20. An underwriting subsidiary may underwrite or deal in ineligible securities issued by (or representing interests in, or secured by, obligations of) affiliates provided the securities are—

(1) rated by an unaffiliated, nationally recognized statistical rating organization, or

(2) issued or guaranteed by FannieMae, FHLMC or GNMA (or represent interests in securities issued or guaranteed by FannieMae, FHLMC, or GNMA).

Comment:

Before revising condition 20 in September 1989, the Board had an absolute prohibition against underwriting or dealing in securities issued by affiliates or representing interests in assets originated by affiliates. This prohibition was designed to mitigate conflicts of interest. In revising condition 20, the Board considered that the unaffiliated rating agency or the relevant government or government-sponsored agency would review the issue and thereby provide a third-party assessment of the assets.

Condition 21(a). Applicants shall ensure that no bank or thrift subsidiary shall, directly or indirectly, extend credit in any manner to an affiliated underwriting subsidiary or a subsidiary thereof; or issue a guarantee, acceptance, or letter of credit, including an endorsement or standby letter of credit, for the benefit of the underwriting subsidiary or a subsidiary thereof.

Comments:

A. The restrictions precluding an affiliated depository from extending credit, including repurchase agreement financing, to an underwriting subsidiary do not apply to companies operating under the 1987 order. However, in conducting an infrastructure review of such a company to permit commencement of expanded powers under the 1989 order, examiners should verify that such funding arrangements can be terminated quickly and alternative funding sources are available.

B. The Board has permitted an underwriting subsidiary (operating under 1989 order) to engage in repurchase and reverse repurchase agreements involving U.S. Treasury securities with certain indirect (that is, Edge corporations) subsidiaries of affiliated banks. The purpose of these transactions is to accommodate the operational needs of foreign subsidiaries and *not* to fund the underwriting subsidiary or its own positions. Approval was conditioned upon the holding company providing the affiliated banks with a *written* guarantee indemnifying the banks against any losses that might arise from the underwriting subsidiary's nonperformance. (See letter to J.P. Morgan Securities, Inc., dated June 19, 1989). Accordingly, examiners should determine whether the underwriting subsidiary engages in repurchase agreements with affiliate banks or their subsidiaries. If so, examiners must verify that the holding company has received specific authority, and, furthermore, insist that operating personnel document and describe how the intercompany repurchase agreements accommodate the operational needs of foreign subsidiaries and are not funding vehicles for the underwriting subsidiary.

C. The 1989 order explicitly recognized that underwriting subsidiaries could act as agent for their affiliate banks in the purchase or sale of financial assets. However, the Federal Reserve Bank of New York enters into transactions with primary dealers only on a principal basis. Thus, in order for an affiliated depository institution to engage in repurchase agreement transactions with the Reserve Bank, the depository institution must first enter into a comparable repurchase agreement transaction with the section 20 subsidiary. Since the section 20 subsidiary would in substance only be acting as agent for its affiliated bank, the Board permitted the section 20 subsidiary to engage in such repurchase and reverse repurchase transactions with its affiliate bank where the terms between the affiliated entities are identical to those with the Reserve Bank. (See letter to Bankers Trust dated July 26, 1989).

Condition 21(b). This prohibition shall not apply to an extension of credit by a bank or thrift to an underwriting subsidiary that is incidental to the provision of clearing services by the bank or thrift to the underwriting subsidiary with respect to securities of the United States or its agencies, or securities on which the principal and interest are fully guaranteed by the United States or its agencies, if the extension of credit is fully secured by such securities, is on market terms, and is repaid on the same calendar day. If the intra-day clearing of such securities cannot be completed because of a *bona fide* fail or operational problem incidental to the clearing process that is beyond the control of the bank or thrift and the underwriting subsidiary, the bank or

thrift may continue the intraday extension of credit overnight provided the extension of credit is fully secured as to principal and interest as described above, is on market terms, and is repaid as early as possible on the next business day.

Comments:

A. Restrictions on clearing eligible or ineligible securities transactions are *not* applicable to companies operating under the 1987 order. However, because of the potential for daylight overdrafts, this prohibition generally acts to prevent section 20 subsidiaries operating under the 1989 order from clearing through affiliated banks or using affiliate bank accounts (if a self-clearing dealer).

B. In an order dated January 4, 1990 (1990 FRB 158), the Board modified this condition to permit bank and thrift affiliates of all section 20 subsidiaries to provide incidental clearance credit with respect to securities of Canada or its agencies, or securities on which the principal and interest are fully guaranteed by Canada or its agencies.

Condition 22. No bank or thrift shall, directly or indirectly, for its own account, purchase financial assets of an affiliated underwriting subsidiary or a subsidiary thereof or sell such assets to the underwriting subsidiary or subsidiary thereof. This limitation shall not apply to the purchase and sale of assets having a readily identifiable and publicly available market quotation and purchased at that market quotation for purposes of section 23A of the Federal Reserve Act (12 U.S.C. 371c(d)(6)), provided that those assets are not subject to a repurchase or reverse repurchase agreement between the underwriting subsidiary and its bank or thrift affiliate.[7]

Comments:

A. Relationships with firms operating under the 1987 order are governed only by section 23A and 23B of the Federal Reserve Act. (See condition 18 of the 1987 order.)

B. In an order dated January 4, 1990 (1990 FRB 158), the Board broadened the purchase and sale exclusion for all section 20 subsidiaries to include direct obligations of both the U.S. Treasury and Canadian federal government.

C. As an exception to this provision, the Board has permitted underwriting subsidiaries to engage in certain swap and options transactions, including interest-rate and foreign-currency swaps and foreign-exchange spot, forward, and futures contracts with an affiliate bank. These transactions are permitted to hedge the underwriting subsidiary's risk exposure and *not* for funding purposes. U.S. Treasury securities must be used to collateralize 100 percent of the risk arising from these transactions, and, furthermore, there must be a daily marking to market. These transactions must also be conducted in accordance with section 23B of the Federal Reserve Act, which requires that purchases and sales of assets between a bank and its affiliates be conducted on terms that would be offered to, or would apply to, unaffiliated companies. The Board also requires a written guarantee indemnifying the affiliate bank against any losses that might arise from the underwriting subsidiary's nonperformance. (See letter to J.P. Morgan Securities, Inc., dated June 19, 1989).

D. The Board has recognized another exception to this condition in which a section 20 subsidiary engages in repurchase and reverse repurchase agreements with respect to U.S. Treasury securities with a foreign subsidiary of the affiliated bank. The purpose of the repurchase and reverse repurchase transactions cannot be to fund the section 20 subsidiary or its operations, but rather must be to accommodate the operational needs of the foreign securities affiliates. These transactions must be secured in accordance with section 23A of the Federal Reserve Act. They must also be conducted at arm's length and not invoke preferential terms or conditions in accordance with section 23B of the Federal Reserve Act. The bank holding company must also provide a written guarantee indemnifying the affiliated bank against any losses that might arise from the underwriting subsidiary's nonperformance. (See letter to J.P. Morgan Securities, Inc., dated June 19, 1989).

E. The Board provided a further exception to the prohibition against purchasing and selling financial assets with insured depository affiliates. An affiliated futures commission merchant is permitted to match offsetting futures transactions from all affiliated entities to avoid violating Commodity Futures Trading Commission rules against sending such orders to an exchange floor. Daily marking to market and posting of collateral is required, as well as a

7. Asset purchases meeting this price-availability standard are exempt from the quantitative and qualitative restrictions on interaffiliated funding in sections 23A and 23B of the Federal Reserve Act.

parent bank holding company's guarantee indemnifying the affiliate bank against any loss that might result from the underwriting subsidiary's nonperformance. (See letter to Bankers Trust New York Corporation dated July 26, 1989).

Limitations on Transfers of Information

Condition 23. No bank or thrift shall disclose to an underwriting subsidiary, nor shall an underwriting subsidiary disclose to an affiliated bank or thrift, any nonpublic customer information (including an evaluation of the creditworthiness of an issuer or other customer of that bank, thrift, or underwriting subsidiary) without the consent of that customer.

Comment:

This condition reinforces securities law that prohibits the release of confidential information without consent. In addition to specifically requesting authorization to release information, there are a number of means for obtaining customer consent. Some companies have linked consent to release information with their customer disclosure form (condition 14). Customers receive a disclosure form and are also advised that unless the section 20 subsidiary receives a written objection, the client is deemed to have consented to the disclosure of nonpublic information from an unaffiliated bank or thrift. In other instances, customers are advised that by continuing to do business with a section 20 subsidiary, it is assumed that the customer has consented.

Reports

Condition 24. Applicants shall submit quarterly to the appropriate Federal Reserve Bank FOCUS reports filed with the NASD or other self-regulatory organizations, and detailed information breaking down the underwriting subsidiaries' business with respect to eligible and ineligible securities, in order to permit monitoring of the underwriting subsidiaries' compliance with the provisions of this order.[8]

Comments:

A. This condition is included to facilitate monitoring of financial condition and compliance with the Board's revenue limitation.

B. The treatment of ''matched book'' repurchase agreement transactions under the Board's two-year revenue test represents a classification issue. Such repurchase agreements involve a dealer functioning as a financial intermediary by executing offsetting repurchase and reverse repurchase agreement transactions. In all instances, the interest income from reverse repos on U.S. government securities is ''eligible'' revenue. The revenue test does *not* require netting of interest income and expense on matched book repos.

C. Another revenue-classification issue pertains to the treatment of ''loans'' versus ''securities.'' Under the SEC's net-capital rule, an unsecured receivable is subject to a 100 percent ''haircut'' against capital. Alternatively, holdings of privately placed investment-grade debt securities (for example, rated ESOP notes) are subject to regular securities haircuts (1 percent to 9 percent). A question may arise as to whether such loans could be treated as ''securities'' for SEC net-capital purposes, and whether the derived interest income and gains (losses) can be treated as eligible revenue (i.e., banks make and sell loans) for section 20 purposes. As in the case of commercial paper (treated as loans on call reports), revenues derived from dealing in ineligible ''securities'' should be classified as ineligible. (See appendix D)

Transfer of Activities and Formation of Subsidiaries of an Underwriting Subsidiary to Engage in Underwriting and Dealing

Condition 25. The Board's approval of the proposed underwriting and dealing activities extends only to the subsidiaries described above for which approval has been sought in the instant applications. The activities may not be conducted by the applicants in any other subsidiary without prior Board review. Pursuant to Regulation Y, no corporate reorganization of any underwriting subsidiary, such as the establishment of subsidiaries of the underwriting subsidiary to conduct the activities, may be consummated without prior Board approval.

8. The Board now requires the quarterly submission of Form FR Y-20, Financial Statements for a Bank Holding Company Subsidiary Engaged in Ineligible Securities Underwriting and Dealing.

Comment:

This condition is intended to prevent movement of section 20 activities to another subsidiary that may not be subject to firewall conditions.

Limitations on Reciprocal Arrangements and Discriminatory Treatment

Condition 26. No applicant nor any of its subsidiaries may, directly or indirectly, enter into any reciprocal arrangement. A reciprocal arrangement means any agreement, understanding, or other arrangement under which one bank holding company (or subsidiary thereof) agrees to engage in a transaction with, or on behalf of, another bank holding company (or subsidiary thereof), in exchange for the agreement of the second bank holding company (or any subsidiary thereof) to engage in a transaction with, or on behalf of, the first bank holding company (or any subsidiary thereof) for the purpose of evading any requirement of this order or any prohibition on transactions between, or for the benefit of, affiliates of banks established pursuant to federal banking law or regulation.

Condition 27. No bank or thrift affiliate of an underwriting subsidiary shall, directly or indirectly—

(a) acting alone or with others, extend or deny credit or services (including clearing services), or vary the terms or conditions thereof, if the effect of such action would be to treat an unaffiliated securities firm less favorably than its affiliated underwriting subsidiary, unless the bank or thrift demonstrates that the extension or denial is based on objective criteria and is consistent with sound business practices; or

(b) extend or deny credit or services or vary the terms or conditions thereof with the intent of creating a competitive advantage for an underwriting subsidiary of an affiliated bank holding company.

Comment:

Conditions 26 and 27 were added in 1989, but merely restate certain principles in the Bank Holding Company Act and, accordingly, should be considered applicable to any underwriting subsidiary.

Requirement for Supervisory Review Before Commencement of Activities

Condition 28. An applicant may not commence the proposed debt and equity securities underwriting and dealing activities until the Board has determined that the applicant has established policies and procedures to ensure compliance with the requirements of this order, including computer, audit, and accounting systems; internal risk-management controls; and the necessary operational and managerial infrastructure. In this regard, the Board will review in one year whether applicants may commence underwriting and dealing in equity securities based on a determination by the Board that they have established the managerial and operational infrastructure and other policies and procedures necessary to comply with the requirements of this order.

Comment:

Procedures for conducting the required review are in the inspection procedures, section 2185.0.5.2, ‘‘Managerial and Operational Infrastructure.’’

2185.0.8 APPENDIX B— 1987 BOARD CONDITIONS

A. Types of Securities to Be Underwritten

Listed below are the Board’s conditions adopted in 1987 that govern underwriting and dealing in certain limited types of ineligible debt securities. Those conditions include a cross-reference to an updated firewall condition in appendix A, and thus facilitate the ready review of related comments if supplemental information is required.

1. The underwriting subsidiaries shall limit their underwriting and dealing in ineligible securities to the following:

a. *Municipal revenue bonds* that are rated as investment quality (that is, in one of the top four categories) by a nationally recognized rating agency, except that industrial development bonds in these categories shall be limited to ‘‘public ownership’’ industrial development bonds (that is, those tax-exempt bonds in which the issuer, or the governmental unit on behalf of

which the bonds are issued, is the sole owner, for federal income tax purposes, of the financed facility (such as airports and mass commuting facilities)).

b. *Mortgage-related securities* (obligations secured by or representing an interest in one- to four-family residential real estate) rated as investment quality (that is, in one of the top four categories) by a nationally recognized rating agency.

c. *Commercial paper* that is exempt from the registration and prospectus requirements of the SEC pursuant to the Securities Act of 1933 and that is short term, of prime quality, and issued in denominations no smaller than $100,000.

d. *Consumer receivable–related securities* that are rated as investment quality.

Comment:

Commercial paper to be underwritten must be of ''prime quality,'' but there is no requirement that an independent rating must be obtained. Thus, in the absence of ratings, commercial paper underwriting policies should be reviewed to determine whether credit standards are comparable to those used for commercial bank lending and investment.

In December 1994, the Board permitted Norwest Corporation to underwrite and deal in unrated municipal revenue bonds under certain circumstances.

B. Capital Investment

2. In determining compliance with the Board's capital adequacy guidelines, each applicant is required to deduct from its consolidated capital any investment it makes in the underwriting subsidiary that is treated as capital in the underwriting subsidiary. In accordance with the risk-based component of the Board's capital guidelines, the applicant must deduct 50 percent of the amount of any investment in the underwriting subsidiary from tier 1 capital and 50 percent from tier 2 capital. If the amount deductible from tier 2 capital exceeds actual tier 2 capital, the excess would be deducted from tier 1 capital. In calculating risk-based capital ratios, the applicant should also exclude the underwriting subsidiary's assets from the holding company's consolidated assets. (This condition is revised to reflect risk-based capital standards.) See appendix A, condition 1(a).

C. Capital Adequacy

3. The underwriting subsidiary shall maintain at all times capital adequate to support its activity and cover reasonably expected expenses and losses in accordance with industry norms. See appendix A, condition 4.

4. Applicants shall submit quarterly to the Federal Reserve Bank of New York FOCUS reports filed with the NASD or other self-regulatory organizations, and detailed information breaking down the underwriting subsidiaries' business with respect to eligible and ineligible securities, in order to permit monitoring of the underwriting subsidiaries' compliance with the provisions of this order. See Appendix A, condition 24.

D. Credit Extensions by Lending Affiliates to Customers of the Underwriting Subsidiary

5. No applicant or subsidiary shall extend credit or, issue or enter into a stand-by letter of credit, asset purchase agreement, indemnity, insurance, or other facility that might be viewed as enhancing the creditworthiness or marketability of an ineligible securities issue underwritten by an affiliated underwriting subsidiary. See appendix A, condition 5.

6. No lending affiliate of an underwriting subsidiary shall knowingly extend credit to a customer secured by, or for the purpose of purchasing, any ineligible security that an affiliated underwriting subsidiary underwrites during the period of the underwriting, or to purchase from the underwriting subsidiary any ineligible security in which the underwriting subsidiary makes a market. This limitation extends to all customers of lending affiliates, including broker-dealers and unaffiliated banks, but does not include lending to a broker-dealer for the purchase of securities in which an affiliated bank is the clearing bank for such broker-dealer. See appendix A, condition 6.

7. No applicant or any of its subsidiaries may make loans to issuers of ineligible securities underwritten by an affiliated underwriting subsidiary for the purpose of the payment of principal and interest on such securities. To ensure compliance with the foregoing, any credit lines extended to an issuer by any lending subsidiary of the bank holding company shall provide for

substantially different timing, terms, conditions, and maturities from the ineligible securities being underwritten. It would be clear, for example, that a credit has substantially different terms and timing if it is for a documented special purpose (other than the payment of principal and interest) or there is substantial participation by other lenders. See appendix A, condition 7.

8. Each applicant shall adopt appropriate procedures, including maintenance of necessary documentary records, to ensure that any extensions of credit to issuers of ineligible securities underwritten or dealt in by an underwriting subsidiary are on an arm's-length basis for purposes other than payment of principal and interest on the issuer's ineligible securities being underwritten or dealt in by the subsidiary. An extension of credit is considered to be on an arm's-length basis if the terms and conditions are substantially the same as those prevailing at the time for comparable transactions with issuers whose securities are not underwritten or dealt in by the underwriting subsidiaries. See appendix A, condition 8.

9. The requirements relating to credit extensions to issuers noted in paragraphs 5–8 above shall also apply to extensions of credit to parties that are major users of projects that are financed by industrial revenue bonds. See appendix A, condition 10.

E. Limitations to Maintain Separateness of an Underwriting Affiliate's Activity

10. Directors, officers, or employees of a bank or thrift shall not serve as a majority of the board of directors or the chief executive officer of an affiliated section 20 subsidiary, and directors, officers, or employees of a section 20 subsidiary shall not serve as a majority of the board of directors or the chief executive officer of an affiliated bank or thrift. The underwriting subsidiary will have separate offices from any bank or thrift subsidiary of the applicant. (An underwriting subsidiary may have offices in the same building as a bank or thrift subsidiary of an applicant if the underwriting subsidiary's offices are clearly distinguished from those of the bank or thrift.)

F. Disclosure by the Underwriting Subsidiary

11. An underwriting subsidiary will provide each of its customers with a special disclosure statement describing the difference between the underwriting subsidiary and its banking affiliates, pointing out an affiliated bank could be a lender to an issuer, and referring the customer to the disclosure document for details. The statement shall also indicate that the obligations of the underwriting subsidiary are not those of any affiliated bank and that the bank is not responsible for securities sold by the underwriting subsidiary. The underwriting subsidiary should disclose any material lending relationship between the issuer and a bank or lending affiliate of the underwriting subsidiary as required under the securities laws and, in every case, whether the proceeds of the issue will be used to repay outstanding indebtedness to affiliates. See appendix A, condition 14.

12. No underwriting subsidiary nor any affiliated bank or thrift institution will engage in advertising or enter into an agreement stating or suggesting that an affiliated bank is responsible in any way for the underwriting subsidiary's obligations. See appendix A, condition 15.

13. *Reserved.*

G. Investment Advice by Bank/Thrift Affiliates

14. An affiliated bank or thrift institution may not express an opinion with respect to the advisability of the purchase of ineligible securities underwritten or dealt in by an underwriting subsidiary unless the bank or thrift affiliate notifies the customer that its affiliated underwriting subsidiary is underwriting or making a market in the security. See appendix A, condition 17.

H. Conflicts of Interest

15. No applicant nor any of its subsidiaries, other than the underwriting subsidiary, shall purchase, as principal, ineligible securities that are underwritten by the underwriting subsidiary during the period of the underwriting and for 60 days after the close of the underwriting period, or shall purchase from the underwriting subsidiary any ineligible security in which the underwriting subsidiary makes a market. See appendix A, condition 19.

16. No applicant nor any of its bank, thrift, or trust or investment advisory company subsidiaries shall purchase, as a trustee or in any other fiduciary capacity, for accounts over which

they have investment discretion, ineligible securities—

(i) underwritten by the underwriting subsidiary as lead underwriter or syndicate member during the period of any underwriting or selling syndicate, and for a period of 60 days after the termination thereof; and

(ii) from the underwriting subsidiary, if it makes a market in that security, unless, in either case, such purchase is specifically authorized under the instrument creating the fiduciary relationship, by court order, or by the law of the jurisdiction under which the trust is administered. See appendix A, condition 18.

17. An underwriting subsidiary may not underwrite or deal in ineligible securities issued by its affiliates or representing interests in, or secured by, obligations originated or sponsored by its affiliate, except for—

a. securities of affiliates, if the securities are rated by a nonaffiliated, nationally recognized rating organization or are issued or guaranteed by the Federal National Mortgage Association, Federal Home Loan Mortgage Corporation, or Government National Mortgage Association, or represent interests in such obligations; and

b. grantor trusts or special-purpose corporations created to facilitate underwriting of securities backed by residential mortgages originated by a nonaffiliated lender. See appendix A, condition 20.

18. All purchases and sales of assets between bank (or thrift) affiliates and an underwriting subsidiary (or third parties in which the underwriting subsidiary is a participant or has a financial interest, acts as agent or broker, or receives a fee for its services) will be at arm's length and on terms no less stringent than those applicable to unrelated third parties, and will not involve low-quality securities, as defined in section 23A of the Federal Reserve Act. See appendix A, condition 22.

I. Limitations to Address Possible Unfair Competition

19. No lending affiliates of an underwriting subsidiary may disclose to the underwriting subsidiary any nonpublic customer information consisting of an evaluation of the creditworthiness of an issuer or other customer of the underwriting subsidiary (other than as required by securities laws and with the issuer's consent), and no officers or employees of the underwriting subsidiary may disclose such information to its affiliates. See appendix A, condition 23.

J. Formation of Subsidiaries of an Underwriting Subsidiary to Engage in Underwriting and Dealing

20. Pursuant to Regulation Y, no corporate reorganization of an underwriting subsidiary, such as the establishment of subsidiaries of the underwriting subsidiary to conduct the activities, may be consummated without prior Board approval. See appendix A, condition 25.

2185.0.9 APPENDIX C—FIREWALL CONDITIONS APPLICABLE TO FOREIGN BANK SUBSIDIARIES

Foreign bank applications to engage in section 20 activities requested relief from several of the firewall conditions on the grounds that strict application would have an inappropriate effect on non-U.S. operations (*CIBC*, 1990 FRB 158). The Board determined that, consistent with the International Banking Act of 1978 and its policy of national treatment, foreign banks must conduct their section 20 activities in the United States. within the framework of prudential limitations established for domestic organizations. However, the Board decided to modify the funding and certain operational requirements of the firewall conditions for foreign banks to prevent U.S. regulation from interfering with operations of foreign banks outside the United States. These modifications are as follows:

1. *Capital Requirements of the Parent Foreign Bank*

A foreign bank would generally be considered to have adequate capital to underwrite or deal in debt or equity securities in the United States if (1) both before and after deduction of investments in and unsecured loans to the underwriting subsidiary, the foreign bank meets the risk-based capital standards established by its home-country supervisor under the Basle Accord; (2) the home-country supervisor informs the Board that the applicant organization is in good standing with the supervisor; (3) the U.S. offices, subsidiary banks, and any U.S. holding company of the foreign bank are in satisfactory condition and adequately capitalized; and (4) other financial and managerial measures indicate that the foreign bank may

be a source of strength to its U.S. banking operations.

2. *Funding of the Section 20 Affiliate*

A section 20 subsidiary may not be funded by an applicant's U.S. bank, thrift, branch, or agency. A foreign bank may be permitted to invest in and lend to the section 20 subsidiary as though the foreign bank is a bank holding company.

3. *Credit Extensions by the Parent Foreign Bank to Customers of the Section 20 Subsidiary*

Conditions 5–12 of the J.P. Morgan order were modified so that they are applicable only to credit transactions by any U.S. bank or nonbank affiliate or office. However, the section 20 subsidiary is prohibited from participating in an underwriting in which the section 20 subsidiary knows that an affiliate (foreign or domestic) is providing credit enhancements.

In addition, the section 20 subsidiary is prohibited from arranging for, or participating in, any arrangement whereby a foreign affiliate provides credit—

(a) to a customer for the purpose of purchasing ineligible securities underwritten or dealt in by the section 20 subsidiary; or

(b) to an issuer for the purpose of paying principal, interest, or dividends on ineligible securities underwritten by the section 20 affiliate.

4. *Transactions between the Section 20 Affiliate and Its Foreign Securities Company Affiliates*

Purchases and sales of securities resulting from bona fide customer demand for securities that have been issued in a simultaneous cross-border offering are permitted. Domestic bank holding companies, as well as foreign banks, are also permitted to use this authority.

5. *Treatment Accorded Canadian Governmental Securities*

Canadian governmental securities are to be treated like U.S. governmental securities for purposes of exemptions from certain firewalls consistent with the U.S.–Canada Free-Trade Agreement. This modification applies to domestic bank holding companies.

6. *Purchase of Securities Where Affiliate Has Investment Discretion*

Condition 18 of the J.P. Morgan order was modified so that it only applied to a U.S. bank, thrift, trust, or investment advisory subsidiary of the foreign bank holding company.

Notwithstanding these modifications, the firewalls are intended to prevent foreign bank applicants from having any significant competitive advantage in the United States over section 20 subsidiaries and non-bank-owned securities firms. A listing of these conditions follows.

A. Capital Adequacy Conditions

1. The applicant must meet internationally accepted risk-based capital requirements before and after deduction from the applicant's consolidated capital of (a) any investment it makes in the underwriting subsidiary that is treated as capital in that subsidiary, and (b) any credit the applicant or a subsidiary extends directly or indirectly to the underwriting subsidiary unless the extension of credit is fully secured by U.S. Treasury securities, securities that are direct obligations of the Canadian federal government, or other marketable securities, and is collateralized in the same manner and to the same extent as would be required under section 23A(c) of the Federal Reserve Act if the extension of credit were made by a member bank.[9]

2. In calculating risk-based capital ratios, the applicant should deduct 50 percent of the amount of any investment in, and 50 percent of any unsecured or not fully secured or inadequately collateralized loans to, the underwriting subsidiary from tier 1 capital and 50 percent from tier 2 capital. The applicant should also exclude the underwriting subsidiary's assets from its consolidated assets. Notwithstanding these adjustments, the applicant should continue to maintain adequate capital on a fully consolidated basis.

3. *Reserved*

4. The underwriting subsidiary shall maintain at all times capital adequate to support its activity and cover reasonably expected expenses and losses in accordance with industry norms.

B. Credit Extensions to Customers of the Underwriting Subsidiary[10]

5. (a) No U.S. affiliate or branch or agency of the applicant shall directly or indirectly extend credit or issue or enter into a stand-by letter of credit, asset purchase agreement,

9. An extension of credit means any loan, guarantee, or other form of credit exposure, including those described in condition 5.

10. Unless otherwise stated, these conditions shall apply to a subsidiary of a bank or thrift institution to the same extent as they apply to the bank or thrift institution.

indemnity, guarantee, insurance, or other facility that might be viewed as enhancing the creditworthiness or marketability of an ineligible securities issue underwritten or distributed by the underwriting subsidiary.

(b) The underwriting subsidiary shall not underwrite or distribute ineligible securities if the underwriting subsidiary is aware in the ordinary course of conducting a due-diligence review that an affiliate is extending credit or issuing or entering into a stand-by letter of credit, asset purchase agreement, indemnity, guarantee, insurance, or other facility that might be viewed as enhancing the creditworthiness or marketability of such ineligible securities.

6. (a) No U.S. affiliate or branch or agency of the applicant (other than the underwriting subsidiary) shall knowingly extend credit to a customer directly or indirectly secured by, or for the purpose of purchasing, any ineligible security that the underwriting subsidiary underwrites during the period of the underwriting or for 30 days thereafter, or to purchase from the underwriting subsidiary any ineligible security in which the underwriting subsidiary makes a market.

(b) The underwriting subsidiary shall not arrange for an applicant or any of its subsidiaries to extend, or knowingly participate in any arrangement whereby an applicant or any of its subsidiaries extends, credit to a customer directly or indirectly secured by, or for the purpose of purchasing, any ineligible security that the underwriting subsidiary underwrites during the period of the underwriting or for 30 days thereafter, or to purchase from the underwriting subsidiary any ineligible security in which the underwriting subsidiary makes a market.

(c) These limitations extend to all customers of the applicant and its subsidiaries, including broker-dealers and unaffiliated banks, but do not include lending to a broker-dealer for the purchase of securities where an affiliated bank is the clearing bank for such broker-dealer.

7. (a) No U.S. affiliate or branch or agency of the applicant may, directly or indirectly, extend credit to issuers of ineligible securities underwritten by the underwriting subsidiary for the purpose of the payment of principal, interest, or dividends on such securities.

(b) The underwriting subsidiary shall not arrange for an applicant or any of its subsidiaries to extend, or knowingly participate in any arrangement whereby an applicant or any of its subsidiaries extends, credit to an issuer of ineligible securities underwritten by the underwriting subsidiary for the purpose of the payment of principal, interest, or dividends on such securities and shall not underwrite any ineligible securities of an issuer if it becomes aware that an affiliate is providing credit to an issuer for such purposes.

(c) These limitations would be inapplicable to any credit lines extended to an issuer by any applicant or any subsidiary of an applicant that provide for substantially different timing, terms, conditions, and maturities from the ineligible securities being underwritten. It would be clear, for example, that a credit has substantially different terms and timing if it is for a documented special purpose (other than the payment of principal, interest, or dividends) or there is substantial participation by other lenders.

8. Each applicant shall adopt appropriate procedures, including maintenance of necessary documentary records, to ensure that any extension of credit by any of its U.S. affiliates, branches, or agencies to issuers of ineligible securities underwritten or dealt in by an underwriting subsidiary are on an arm's-length basis for purposes other than payment of principal, interest, or dividends on the issuer's ineligible securities being underwritten or dealt in by the underwriting subsidiary. An extension of credit is considered to be on an arm's-length basis if the terms and conditions are substantially the same as those prevailing at the time for comparable transactions with issuers whose securities are not underwritten or dealt in by the underwriting subsidiary.

9. In any transaction involving an underwriting subsidiary, an applicant's thrift subsidiaries shall observe the limitations of sections 23A and 23B of the Federal Reserve Act as if the thrifts were banks.[11]

10. The requirements relating to credit extensions to issuers noted in paragraphs 5–9 above shall also apply to extensions of credit to parties that are major users of projects that are financed by industrial revenue bonds.

11. Applicants shall cause their U.S. bank and thrift subsidiaries, branches, and agencies to adopt policies and procedures, including appropriate limits on exposure, to govern their participation in financing transactions underwritten or arranged by an underwriting subsidiary as set forth in this order. The Reserve Banks shall ensure that these policies and procedures are in

11. The Board notes that the applicants in these cases do not currently own thrift subsidiaries in the United States. The Board is including this limitation as part of a general framework for foreign banks operating in the United States.

place at the applicants' U.S. bank and thrift subsidiaries, branches, and agencies and shall ensure that loan documentation is available for review by Reserve Banks to ensure that an independent and thorough credit evaluation has been undertaken in connection with the participation by the bank, thrift, branch, or agency in such financing packages and that such lending complies with the requirements of this order and section 23B of the Federal Reserve Act.

12. The applicants' U.S. bank and thrift subsidiaries and branches and agencies should also establish appropriate policies, procedures, and limitations regarding exposure of the applicants' U.S. subsidiaries and offices on a consolidated basis to any single customer whose securities are underwritten or dealt in by the underwriting subsidiary.

C. Limitations to Maintain Separateness of an Underwriting Affiliate's Activity

13. Directors, officers, or employees of the applicant's U.S. bank or thrift subsidiaries, branches, or agencies shall not serve as a majority of the board of directors or the chief executive officer of an affiliated section 20 subsidiary, and directors, officers, or employees of a section 20 subsidiary shall not serve as a majority of the board of directors or the chief executive officer[12] of an affiliated U.S. bank or thrift subsidiary, branch, or agency of an applicant, except that the manager of a branch or agency may act as a director of the underwriting subsidiary. The underwriting subsidiary will have separate offices from any bank or thrift subsidiary or branch or agency of the applicant.[13]

D. Disclosure by the Underwriting Subsidiary

14. An underwriting subsidiary will provide each of its customers with a special disclosure statement describing the difference between the underwriting subsidiary and its bank and thrift affiliates and its U.S. branches and agencies and pointing out that an affiliated bank or thrift or U.S. branch or agency could be a lender to an issuer and referring the customer to the disclosure documents for details. In addition, the statement shall state that securities sold, offered, or recommended by the underwriting subsidiary are not deposits, are not insured by the Federal Deposit Insurance Corporation, are not guaranteed by an affiliated bank or thrift or branch or agency, and are not otherwise an obligation or responsibility of such a bank or thrift or branch or agency (unless such is the case). The underwriting subsidiary should also disclose any material lending relationship between the issuer and a bank or lending affiliate of the underwriting subsidiary as required under the securities laws and in every case, to the extent known, whether the proceeds of the issue will be used to repay outstanding indebtedness to affiliates.

E. Marketing Activities on Behalf of an Understanding Subsidiary

15. No underwriting subsidiary nor any affiliated U.S. bank or thrift institution, branch, or agency will engage in advertising or enter into an agreement stating or suggesting that an affiliated U.S. bank, thrift, branch, or agency is responsible in any way for the underwriting subsidiary's obligations as required for affiliates of member banks under section 23B of the Federal Reserve Act.

16. *Reserved*

F. Investment Advice by Bank/Thrift Affiliates, Branches, and Agencies

17. An affiliated U.S. bank or thrift institution or a U.S. branch or agency may not express an opinion on the value or the advisability of the purchase or the sale of ineligible securities underwritten or dealt in by an affiliated underwriting subsidiary unless the affiliated institution, branch, or agency notifies the customer that the underwriting subsidiary is underwriting, making a market, distributing, or dealing in the security.

18. No U.S. bank, thrift, or trust or investment advisory subsidiaries, or U.S. branches or agencies, of an applicant shall purchase, as a trustee or in any other fiduciary capacity, for accounts over which they have investment discretion ineligible securities (a) underwritten by the underwriting subsidiary as lead underwriter or syndicate member during the period of any underwriting or selling syndicate, and for a

12. For purposes of this firewall, the manager of a U.S. branch or agency of a foreign bank normally will be considered to be the chief executive officer of the branch or agency.

13. An underwriting subsidiary may have offices in the same building as a bank or thrift subsidiary or branch or agency of the applicant if the underwriting subsidiary's offices are clearly distinguished from those of the bank, thrift, branch, or agency.

period of 60 days after the termination thereof, and (b) from the underwriting subsidiary if it makes a market in that security, unless, in either case, such purchase is specifically authorized under the instrument creating the fiduciary relationship, by court order, or by the law of the jurisdiction under which the trust is administered.

G. Extensions of Credit and Purchases and Sales of Assets

19. An underwriting subsidiary may not sell to any affiliate that is acting as principal in the transaction, ineligible securities that are underwritten by the underwriting subsidiary during the period of the underwriting and for 60 days after the close of the underwriting period, or any ineligible security in which the underwriting subsidiary makes a market, except that, in the case of ineligible securities that are being issued in a simultaneous cross-border underwriting in which the underwriting subsidiary and a foreign affiliate or affiliates are participating, such securities may be purchased or sold pursuant to an intersyndicate agreement for the period of the underwriting where the purchase or sale results from bona fide indications of interest from customers. Such purchases or sales shall not be made for purposes of providing liquidity or capital support to the underwriting subsidiary or otherwise to evade the requirements of this order. An underwriting subsidiary shall maintain documentation on such transactions.

20. An underwriting subsidiary may not underwrite or deal in any ineligible securities issued by its affiliates or representing interests in, or secured by, obligations originated or sponsored by its affiliates (except for grantor trusts or special purpose corporations created to facilitate underwriting of securities backed by assets originated by a non-affiliated lender) unless such securities are rated by an unaffiliated, nationally recognized rating organization or are issued or guaranteed by the Federal National Mortgage Association, the Federal Home Loan Mortgage Corporation, or the Government National Mortgage Association or represent interests in securities issued or guaranteed by such agencies.

21. (a) Applicants shall ensure that no U.S. bank or thrift subsidiary, branch, or agency shall, directly or indirectly, extend credit in any manner to an affiliated underwriting subsidiary or a subsidiary thereof; or issue a guarantee, acceptance, or letter of credit, including an endorsement or standby letter of credit, for the benefit of the underwriting subsidiary or a subsidiary thereof.

(b) This prohibition shall not apply to an extension of credit by an affiliated bank or thrift subsidiary, branch, or agency to an underwriting subsidiary that is incidental to the provision of clearing services by such affiliate, branch, or agency to the underwriting subsidiary with respect to securities of the United States or Canada or their agencies, or securities on which the principal and interest are fully guaranteed by the United States or Canada or their agencies, if the extension of credit is fully secured by such securities, is on market terms, and is repaid on the same calendar day. If the intraday clearing of such securities cannot be completed because of a bona fide fail or operational problem incidental to the clearing process that is beyond the control of the affiliate, branch, or agency and the underwriting subsidiary, the affiliate, branch, or agency may continue the intraday extension of credit overnight provided the extension of credit is fully secured as to principal and interest as described above, is on market terms, and is repaid as early as possible on the next business day.

22. No bank or thrift subsidiary (or U.S. branch or agency of a foreign bank) shall, directly or indirectly, for its own account, purchase financial assets of an affiliated underwriting subsidiary or a subsidiary thereof or sell such assets to the underwriting subsidiary or subsidiary thereof. This limitation shall not apply to the purchase and sale of assets having a readily identifiable and publicly available market quotation and purchased at that market quotation for purposes of section 23A of the Federal Reserve Act (12 U.S.C. 371c(d)(6)), provided those assets are not subject to a repurchase or reverse repurchase agreement between the underwriting subsidiary and its bank or thrift affiliate.

H. Limitations on Transfers of Information

23. No U.S. bank, thrift, branch, or agency shall disclose to an affiliated underwriting subsidiary, nor shall an underwriting subsidiary disclose to an affiliated bank, thrift, branch, or agency, any nonpublic customer information (including an evaluation of the creditworthiness of an issuer or other customer of that bank,

thrift, branch, agency, or underwriting subsidiary) without the consent of that customer.

I. Reports

24. Applicants shall submit to the appropriate Federal Reserve Bank quarterly FOCUS reports filed with the NASD or other self-regulatory organizations, and detailed information breaking down the underwriting subsidiaries' business with respect to eligible and ineligible securities, in order to permit monitoring of the underwriting subsidiaries' compliance with the provisions of this order.

J. Transfer of Activities and Formation of Subsidiaries of an Underwriting Subsidiary to Engage in Underwriting and Dealing

25. The Board's approval of the proposed underwriting and dealing activities extends only to the subsidiaries described above for which approval has been sought in the instant applications. The activities in the United States may not be conducted by the applicants in any other subsidiary without prior Board review. Pursuant to Regulation Y, no corporate reorganization of an underwriting subsidiary, such as the establishment of subsidiaries of the underwriting subsidiary to conduct the activities, may be consummated without prior Board approval.

K. Limitations on Reciprocal Arrangements and Discriminatory Treatment

26. No applicant nor any of its subsidiaries may, directly or indirectly, enter into any reciprocal arrangement. A reciprocal arrangement means any agreement, understanding, or other arrangement under which one bank holding company (or subsidiary thereof) agrees to engage in a transaction with, or on behalf of, another bank holding company (or subsidiary thereof), in exchange for the agreement of the second bank holding company (or any subsidiary thereof) to engage in a transaction with, or on behalf of, the first bank holding company (or any subsidiary thereof) for the purpose of evading any requirement of this order or any prohibition on transactions between, or for the benefit of, affiliates of banks established pursuant to federal banking law or regulation.

27. No U.S. bank or thrift subsidiary or branch or agency of an applicant shall, directly or indirectly—

(a) acting alone or with others, extend or deny credit or services (including clearing services), or vary the terms or conditions thereof, if the effect of such action would be to treat an unaffiliated securities firm less favorably than its affiliated underwriting subsidiary, unless the bank, thrift, branch, or agency demonstrates that the extension or denial is based on objective criteria and is consistent with sound business practices; or

(b) extend or deny credit or services or vary the terms or conditions thereof with the intent of creating a competitive advantage for an underwriting subsidiary of an affiliated bank holding company.

L. Requirement for Supervisory Review Before Commencement of Activities

28. An applicant may not commence the proposed debt or equity securities underwriting and dealing activities until the Board has determined that the applicant has established policies and procedures to ensure compliance with the requirements of this order, including computer, audit, and accounting systems; internal risk-management controls; and the necessary operational and managerial infrastructure. In this regard, the Board will review whether an applicant may commence underwriting and dealing in equity securities based on a determination by the Board that the underwriting subsidiary has established the managerial and operational infrastructure and other policies and procedures necessary to comply with the requirements of this order.

2185.0.10 APPENDIX D—BOARD CONDITIONS FOR PRIVATE-PLACEMENT AND RISKLESS-PRINCIPAL TRANSACTIONS

A. Private Placement

A bank holding company or its subsidiary may act as agent for the private placement of securities in accordance with the requirements of the Securities Act of 1933 and the Rules of the Securities and Exchange Commission, if the company engaged in the activity does not pur-

chase or repurchase for its own account the securities being placed, or hold in inventory unsold portions of issues of these securities. See section 225.28(b)(7)(iii) of Regulation Y.

B. Riskless Principal

1. A bank holding company or its subsidiary may engage in buying and selling in the secondary market all types of securities on the order of customers as a riskless principal to the extent of engaging in a transaction in which the company, after receiving an order to buy (or sell) a security from a customer, purchases (or sells) the security for its own account to offset a contemporaneous sale to (or purchase from) the customer. This does not include—

(a) selling bank-ineligible securities at the order of a customer that is the issuer of the securities, or selling bank-ineligible securities in any transaction in which the company has a contractual agreement to place the securities as agent of the issuer; or

(b) acting as a riskless principal in any transaction involving a bank-ineligible security for which the company or any of its affiliates acts as an underwriter (during the period of the underwriting or for 30 days thereafter) or dealer. In this regard, a company or its affiliates may not enter quotes for specific bank-ineligible securities in any dealer quotation system in connection with the company's riskless-principal transactions; except that the company and its affiliates may enter ''bid'' or ''ask'' quotations, or publish ''offering wanted'' or ''bid wanted'' notices on trading systems other than NASDAQ or an exchange, if the company or its affiliates does not enter price quotations on different sides of the market for a particular security during any two-day period.

2. See 12 C.F.R. 225.28(b)(7)(ii).

Comment:

It is permissible for one side of a riskless-principal transaction to be scheduled for settlement before the regular-way settlement date for the underlying security. However, the other side of the transaction must be scheduled to settle on or before the regular-way settlement date (for example, providing immediate funds by purchasing a municipal revenue bond for cash settlement, but settling the sell side the regular way).

2185.0.11 APPENDIX E—Sample First Day Letter

Mr./Ms. President
XYZ Securities Corporation
New York, NY 10015

Dear Mr./Ms.

As requested, we plan to begin our inspection (or review of the managerial and operational infrastructure) at (company) on _____. To facilitate this inspection (or review), please provide the following information.

Internal Controls

1. Provide an organization chart (i.e., organizational units and number of staff in each) for (company) and any (holding company) unit that provides services to (company), and the responsibilities of each organizational unit. Indicate also the name of the officer or supervisor that heads each unit and include copies of biographies or SEC Form U-4 (''Uniform Application for Securities Industry Registration or Transfer'') for those individuals. Also include an organization chart for (company's) subsidiaries, a listing of each subsidiary's responsibilities, and the name of the officer that heads each unit.
2. Describe generally the transactional procedures for underwriting and trading activities (e.g., steps taken prior to underwriting, preparation of transaction accounting tickets, confirmation of transactions).
3. Provide the procedures that have been established by the (holding company) organization to ensure organizational compliance with the Board of Governors' conditions of approval, including how these procedures are communicated to the appropriate areas of the (holding company) organization.
4. Identify the entity(ies) that will clear (company's) securities transactions.

Risk-Management Control

1. Provide the policies established by (company's) board of directors on the types of securities that can be underwritten and traded and on position limitations (by security, by trader, and for the subsidiary in the aggregate), as well as documentation on how such policies are implemented.
2. Describe the procedures that are used to monitor position limitations and other restrictions imposed by the board of directors.
3. Provide the standards that have been established for securities that are to be underwritten or traded.

2185.0.11 APPENDIX E—Sample First Day Letter—Continued

4. Describe the analyses that are undertaken prior to underwriting or trading of securities (e.g., credit analysis, market acceptability).
5. Provide the policies and procedures that exist on risk-reduction techniques (e.g., hedging, syndications).
6. Describe the insurance coverage related to securities activities, including coverage maintained by (holding company) for (company) and coverage acquired by (company) directly.

Accounting System

1. Describe the accounting system and procedures (with flowcharts), and the reports produced by the system for underwriting and trading activities, including origination of data, data entry, posting of accounts, reconciliation of underwriting commitments and trading positions, and revaluation procedures.
2. Provide a descriptive chart of accounts (all general ledger accounts) used by (company).
3. Provide financial statements and requested documentation as of (most recent quarter) including—
   (a) (company) balance sheet;
   (b) (company) income statement;
   (c) (company) general ledger trial balance and adjustments, if any, required to prepare the FOCUS report and the FR Y-20;
   (d) (holding company) consolidated financial statements, and accounting adjustments to (company's) financial statements required in preparing Federal Reserve Form FR Y-9C; and
   (e) consolidated leverage and risk-based capital ratios, including and excluding (company) and accounting adjustments required in ''deconsolidation.''

Computer System

1. Provide a description of all internal and external computer systems (include software and service arrangements) and a list of all applications on the systems.
2. Provide written EDP emergency plans, detailing equipment and data-file backup, including documentation evidencing testing of emergency plans and backup arrangements.
3. For any external computer systems and service arrangements, provide documentation on recent internal and external audit reviews of the servicer and recent financial reports.

Audit Program

1. Identify the department and officers responsible for conducting internal audits of (company), and provide brief biographies of key audit individuals.

2185.0.11 APPENDIX E—Sample First Day Letter—Continued

2. Provide copies of the (past year) and (current year) audit plans for (company).
3. Provide a list of audits related to (company's) activities conducted in (the past year) and (current year) to date, and copies of these reports.
4. Have available for review a full set of the audit procedures employed, including those drafted for audits of the new securities powers and the control procedures to ensure compliance with the conditions of the Board's applicable section 20 order(s).
5. Provide a copy of the most recent report of examination by (company's) primary regulator (e.g., NASD, NYSE).

Other

1. Provide a listing showing names and business affiliations of directors and officers of (company).
2. Provide copies of parent company guaranty indemnifying affiliate banks against losses in furnishing approved swap and option transactions, etc., if (company) has received Board authorization to engage in these types of transactions.
3. Provide copies of any service agreements between (company) and its affiliated banks and thrifts.

Sincerely yours,

Federal Reserve Bank of New York

2185.0.12 APPENDIX F—PREPARING FOR INSPECTION

Examiners are encouraged to obtain certain materials from the Reserve Bank examination or applications areas before commencing an inspection. This appendix has been prepared to identify materials that ordinarily would not be requested in the ''first day letter.'' A listing of recommended materials follows.

1. Obtain the specific Board order(s) authorizing the underwriting subsidiary to engage in section 20 activities.

2. Obtain any other Board orders referenced in the instant order.

3. For companies that have commenced activities in expanded debt/equity securities powers, obtain a copy of the Board letter or order acknowledging the Reserve Bank's conclusion that applicant has a satisfactory managerial and operational infrastructure.

A. If the Board's letter authorizing the company to commence expanded debt/equity securities powers limits the section 20 subsidiary to a specific level of activity contained in the applicant's capital plan, a copy of such business projections should be obtained from the applications area.

B. If the Board conditioned its approval to commence expanded debt/equity security powers upon raising additional holding company capital, written documentation of performance should be obtained from the applications area.

4. Obtain copies of SEC FOCUS Reports and FR Y-20 reports filed since the previous inspection.

2185.0.13 APPENDIX G—LETTERS MODIFYING CONDITIONS

G-1

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D.C. 20551

ADDRESS OFFICAL CORRESPONDENCE
TO THE BOARD

JUN 19 1989

J.P. Morgan Securities, Inc.
23 Wall Street
New York, NY 10015

This is to advise that the Board of Governors has reviewed the report of the Federal Reserve Bank of New York relating to the operational and managerial infrastructure of J.P. Morgan Securities, Inc. (JPMS), New York, New York, in accordance with the terms of the Board's order of January 18, 1989. The Board has also reviewed the capital plan of J.P. Morgan & Co. Incorporated (Morgan), New York, New York, and its proposals for funding JPMS.

On the basis of this review, the Board has determined that Morgan and JPMS have complied with the requirements of the Board's order, and that JPMS may commence to underwrite and deal in debt securities as permitted by that order.

Morgan has also sought confirmation that three types of transactions currently engaged in by JPMS and Morgan Guaranty Trust Company of New York, New York, New York, or Morgan Bank (Delaware), Wilmington, Delaware (hereafter referred to severally and collectively as Morgan Bank), would not be prohibited by the conditions in the Board's order. First, JPMS currently engages in repurchase and reverse repurchase agreements involving U.S. Treasury securities with certain indirect foreign subsidiaries of Morgan Bank. The purpose of these transactions is to accommodate the operational needs of those foreign subsidiaries and not to fund JPMS or its own positions.

Second, JPMS currently engages in certain swap and options transactions, including interest rate and foreign currency swaps and foreign exchange spot, forward and futures contracts, with Morgan Bank. According to JPMS, the sole purpose of these transactions is to hedge the exposure of JPMS, and these transactions are not to be engaged in for the purpose of funding

2185.0.13 APPENDIX G—LETTERS MODIFYING CONDITIONS—Continued

JPMS. Furthermore, JPMS has committed to collateralize with U.S. Treasury securities 100 percent of the risk arising from these transactions, and the exposure will be marked to market each day.

On the basis of the above assurances and the facts and circumstances of this case, the Board has determined that JPMS may continue to engage in these two types of transactions as long as Morgan provides Morgan Bank with a written guarantee indemnifying the bank against any losses that might arise from JPMS' nonperformance. In making this determination, the Board noted that the purchase and sale of assets between JPMS and Morgan Bank are subject to the provisions of section 23B of the Federal Reserve Act, and thus the terms and conditions of these transactions may not be more favorable than those offered to unaffiliated parties.

Third, JPMS seeks a Board determination that certificates of deposit and bankers' acceptances, including such instruments issued by or accepted by Morgan Bank, may be used to collateralize extensions of credit from Morgan in amounts equal to 100 percent of the value of the loans. The Board finds that under the circumstances presented the use of these instruments as collateral would be consistent with the requirements of the Board's order. The Board has also reviewed the arrangements between Morgan and JPMS with respect to JPMS' holding of certificate of deposit issued by, and bankers' acceptances accepted by, Morgan Bank and determined that, as the transaction has been structured, a capital deduction from Morgan is not required under the Board's order.

These determinations are limited to issues raised under the Bank Holding Company Act of 1956, as amended, and are not intended to address any other laws or regulations that apply to the operations of JPMS. Furthermore, these determinations are based on information that Morgan has presented to the Federal Reserve. Any material changes in the information relied upon could result in the Board arriving at different conclusions.

Sincerely,

(signed) William W. Wiles
William W. Wiles
Secretary of the Board

2185.0.13 APPENDIX G— LETTERS MODIFYING CONDITIONS—Continued

G-3

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D.C.

ADDRESS OFFICAL CORRESPONDENCE
TO THE BOARD

July 26, 1989

Bankers Trust New York Corporation
280 Park Avenue
New York,NY 10014

The Board of Governors has reviewed the report of the Federal Reserve Bank of New York relating to the operational and managerial infrastructure of BT Securities Corporation (BTSC), New York, New York, in accordance with the terms of the Board's order of January 18, 1989. The Board has also reviewed the capital plan of the Bankers Trust New York Corporation (BTNY) and its proposal for funding BTSC.

On the basis of this review, the Board has determined that BTNY and BTSC have complied with the requirements of the Board's order and that BTSC may commence to underwrite and deal in debt securities as permitted by that order. In making this determination, the Board has relied on the commitments of BTNY as contained in its capital plan, including its commitments to raise additional Tier 1 capital within 60 days and to cease exercising the additional powers authorized in January in the event such commitments are not fulfilled. Further, as required by the January 18 order, the Board expects BTSC to maintain capital adequate to support any expanded securities activities and, in this regard, will consult with the Federal Reserve Bank of New York.

To ensure that any perpetual preferred stock issued in connection with BTNY's capital plan meets the permanence requirement for Tier 1 Capital, any redemption of such preferred shares may be only at BTNY's option and only with prior Federal Reserve approval. This would also foster consistency with emerging international norms for the inclusion of preferred shares. The Federal Reserve would expect to grant approval where the shares are redeemed with the proceeds of a Tier 1 capital instrument that would maintain or strengthen the capital base, or where the Federal Reserve determines that the issuer's capital position after the redemption would clearly be adequate and that the issuer's condition and circumstances warrant the reduction of a source of permanent capital.

2185.0.13 APPENDIX G—LETTERS MODIFYING CONDITIONS—Continued

One member of the Board, while fully supporting these additional powers for bank holding companies, dissents from the Board's decision to accept BTNY'S capital plan. He would require that the full amount of the Tier 1 capital called for in BTNY's plan be raised before BTSC commences any new underwriting activities. In addition, he believes that the complete reliance on preferred stock in BTNY's capital commitment is inconsistent with the capital adequacy requirements of the January 18 order.

In its capital plan, BTSC has sought permission to engage in certain repurchase and reverse repurchase agreements with indirect foreign subsidiaries of Bankers Trust Company, and certain swap and options transactions with Bankers Trust Company, that the Board has previously determined, by letter dated June 19, 1989, to J.P. Morgan Securities, Inc., were consistent with the conditions in the January 18 order. The Board has determined that BTSC may engage in these transactions to the same extent, and subject to the same restrictions, as are set forth in that letter.

BTNY has also sought clarification whether the grantor trust exemption in condition 20 of the January 18 order is limited to situations involving mortgage-backed securities. The Board confirms that the grantor trust exemption is not limited to residential mortgages originated by a non-affiliated lender, but includes any and all assets originated by an unaffiliated lender, including consumer receivables.

BTNY also raised questions about separate requirements of the Commodities Futures Trading Commission (CFTC) and the Federal Reserve Bank of New York for certain transactions booked by BTSC. According to BTNY, because it may be a violation of CFTC rules for a future commission merchant to send two offsetting transactions by affiliate entities to an exchange floor, the futures commission merchant must match the two transactions by an internal accounting entry. If the affiliates in question were BTSC and Bankers Trust Company, the effect of the trader's action would be to book a futures position to each of the entities. The Board does not believe that this transaction, under the circumstances set forth by BTSC, is inconsistent with the intent of the January 18 order prohibiting a bank from extending credit to, purchasing assets from, or selling assets to a section 20 affiliate.

The Open Market Desk of the Federal Reserve Bank of New York enters into transactions with primary dealers only on a principal basis, even where the primary dealer discloses that it is acting as a broker on behalf of a customer. Accordingly, where BTSC is the primary dealer, it would also be a principal with respect to its customer, which could be Bankers Trust Company. BTNY has asked whether the January 18 order prohibits repurchase and reverse repurchase transactions between the

2185.0.13 APPENDIX G—LETTERS MODIFYING CONDITIONS—Continued

Reserve Bank and BTSC, where BTSC is acting on behalf of Bankers Trust Company.

The January 18 order explicitly recognized that section 20 subsidiaries could act as agent for their affiliate banks in the purchase or sale of financial assets. The Board believes that BTSC may engage in the proposed repurchase and reverse repurchase transactions on behalf of Bankers Trust Company since the role of BTSC is functionally and substantively one of agent, even though BTSC must technically act as principal in its dealings with the Reserve Bank. This determination is limited to those transactions that are initiated with the Federal Reserve Bank of New York and where the terms between Bankers Trust Company and BTSC are the same as those between the Reserve Bank and the primary dealer.

With respect to both the futures commission merchant and primary dealer transactions described above, BTNY must provide Bankers Trust Company with a written guarantee indemnifying the bank against any losses that might arise from BTSC's nonperformance. In this regard, a copy of any guarantees issued by BTNY in accordance with the provisions of this letter should be provided to the Board.

These determinations are limited to issues raised under the Bank Holding Company Act of 1956, as amended, and are not intended to address any other laws or regulations that apply to the operations of BTSC. Furthermore, these determinations are based on information that BTNY has presented to the Federal Reserve. Any material changes in the information relied upon could result in the Board arriving at different conclusions.

Very truly yours,

[SIGNATURE]

Jennifer J. Johnson
Associate Secretary of the Board

cc: Federal Reserve Bank of New York

2185.0.13 APPENDIX G—LETTERS MODIFYING CONDITIONS—Continued

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D.C. 20551

J. VIRGIL MATTINGLY, JR.
GENERAL COUNSEL

October 3, 1989

Bankers Trust New York Corporation
280 Park Avenue
New York, NY 10014

By letter dated July 26, 1989, the Board determined that BT Securities Corporation (BTSC), New York, New York, could commence to underwrite and deal in debt securities as permitted by the Board's order of January 18, 1989, and responded to several requests by Bankers Trust New York Corporation, New York, New York, for clarification of the conditions set forth in that order. The purpose of this letter is to respond to two additional matters you have raised.

Bankers Trust has requested confirmation of its view that asset sales at fair market value from a bank holding company or its nonbank subsidiaries to a section 20 subsidiary would not be inconsistent with condition 2 of the January 18 order. That condition requires prior notice to and approval by the Board for all provisions of funds, including transfers of assets, by a bank holding company to its section 20 subsidiary. Bankers Trust submission stated that the trade tickets for all such transactions will be time-stamped at the time of the trade so that the Federal Reserve would be able to conduct an after-the-fact review of the fairness of the trades.

Condition 2, by its terms, was intended to cover those transactions that directly or indirectly represent a capital injection. Accordingly, asset sales by the holding company to the section 20 subsidiary at fair market value under the circumstances as described in your submission would not be prohibited by condition 2.

Bankers Trust has also sought confirmation that interest rate or foreign currency swaps, and any derivative agreements, entered into between Bankers Trust Company and a customer of BTSC should not be deemed an extension of credit or similar transaction that might be viewed as enhancing the creditworthiness or marketability of ineligible securities underwritten by the section 20 subsidiary within the meaning of condition 5 of the January 18 order.

2185.0.13 APPENDIX G—LETTERS MODIFYING CONDITIONS—Continued

Condition 5 was intended to restrict those types of activities that have the effect of placing the affiliate bank's credit behind the securities themselves. The types of credit enhancements specifically referred to in the January 18 order were extensions of credit, stand-by letters of credit, asset purchase agreements, indemnification, guarantees, and insurance. While the availability of a swap transaction that changes the form of interest payments might make a debt securities issue more attractive to a customer, it would not place the bank's credit behind the securities being underwritten.

In arriving at this conclusion, I have relied upon Bankers Trust's statement that in each case Bankers Trust Company would make an independent evaluation of the customer's request for an interest rate or currency swap that is not based on the value of the securities underwritten by the section 20 subsidiary. I would also point out that the transactions between the bank and the customer would be subject to both section 23B of the Federal Reserve Act and section 106 of the Bank Holding Company Act. Section 23B would require that the swap transaction between the bank and that customer be on nonpreferential terms. The anti-tying provisions in section 106 would prohibit the section 20 subsidiary from requiring that the customer enter into the swap agreement with the affiliated bank and the bank from reducing its price for that service.

These determinations are based on information that Bankers Trust has presented to the Federal Reserve. Any material changes in the information relied upon could result in different conclusions.

Very truly yours,

[SIGNATURE]

J. Virgil Mattingly, Jr.

2185.0.13 APPENDIX G—LETTERS MODIFYING CONDITIONS—Continued

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D.C. 20551

ADDRESS OFFICAL CORRESPONDENCE
TO THE BOARD

December 5, 1994

Norwest Corporation
Sixth and Marquette
Minneapolis, Minnesota 55479-1026

This responds to your letters requesting, on behalf of Norwest Corporation, Minneapolis, Minnesota ("Norwest"), modification of a commitment to which Norwest's section 20 company, Norwest Investment Services, Inc. ("Company"), is currently subject, to allow Company to underwrite and deal in certain unrated municipal revenue bonds. You also request that Norwest's subsidiary banks be permitted to engage in the following activities with respect to Company:

- Norwest's subsidiary banks would send materials describing Company and Company's services to their retail and commercial customers directly or as a stuffer to bank statements;

- officers and employees of Norwest's subsidiary banks would send materials and letters on bank letterhead describing Company and Company's services to their retail and commercial customers;

- Norwest's subsidiary banks would sponsor or co-sponsor with Company educational seminars to inform retail and commercial customers about investment opportunities, investment strategies, and Company's services; and

- officers and employees of Norwest's subsidiary banks would send invitations on bank letterhead inviting their customers to attend the

2185.0.13 APPENDIX G—LETTERS MODIFYING CONDITIONS—Continued

educational seminars sponsored or co-sponsored by Norwest's subsidiary banks.

On December 20, 1989, the Board approved Norwest's application to engage, through Company, in underwriting and dealing in, to a limited extent, certain bank-ineligible securities.[1] In approving that application, the Board relied, in part, on Norwest's commitment that Company would underwrite and deal in only those municipal revenue bonds that are rated in one of the top four categories by a nationally recognized rating agency. Norwest also committed that no bank or thrift affiliate of Company would act as agent for, or engage in marketing activities on behalf of, Company.

Underwriting unrated municipal revenue bonds. Norwest has requested permission to allow Company to underwrite and deal in unrated municipal revenue bonds under certain circumstances. In this regard, Norwest has committed that Company will not underwrite or deal in any unrated municipal revenue bonds until Norwest's Capital Markets Credit staff conducts an independent credit review and determines that the securities are of investment-grade quality, and that no single issue of unrated municipal revenue bonds underwritten by Company will exceed $7.5 million. In addition, Norwest has committed that official statements and other information supplied to purchasers will state that the securities being sold are not rated; there will be no indication whatsoever that Company or Norwest deems the securities to be of investment-grade quality; and the securities will not be sold by any of Norwest's bank or nonbank subsidiaries, other than Company.

Based on all the facts of record, including those commitments made by Norwest in connection with this request, the Board hereby grants Norwest's request to allow Company to underwrite and deal in unrated municipal revenue bonds. In granting this request, the Board has relied on the credit evaluation packages that Norwest's Capital Markets Credit staff will use to review unrated municipal revenue bonds that Company would like to underwrite or in which Company would like to deal.

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[1] As used in this letter, "bank-ineligible securities" refers to securities that a bank may not underwrite or deal in directly under section 16 of the Glass-Steagall Act (12 U.S.C. § 24 (Seventh)).

2185.0.13 APPENDIX G—LETTERS MODIFYING CONDITIONS—Continued

- 3 -

Cross-marketing. The cross-marketing limitation to which Norwest committed is intended, in part, to ensure that the bank affiliates of a section 20 company do not become involved in the underwriting, dealing, or distribution of bank-ineligible securities sold by the section 20 company. The cross-marketing restriction also is intended to ensure that the public does not link the economic fortunes of a financial institution with an affiliated section 20 company. In J.P. Morgan & Co. Incorporated, et al.,[2] the Board indicated that the purposes of the cross-marketing firewall do not require a complete prohibition of marketing activities, and the Board has permitted banks to act as riskless principal or broker for customers in buying and selling bank-eligible securities underwritten by, or held in the dealing portfolio of, a section 20 affiliate.[3]

Norwest has committed that bank-ineligible underwriting or dealing services offered by Company will not be mentioned or marketed in any manner in materials provided to bank customers or during educational seminars, and that bank employees who attend the educational seminars will not market or provide advice relating to bank-ineligible securities underwritten or dealt in by Company, even if seminar attendees request advice relating to such securities. As required under the firewalls, Norwest also has committed that sales literature relating to bank-ineligible securities underwritten or dealt in by Company will not be distributed by Norwest's subsidiary banks to their customers either through the mail or during educational seminars. In addition, to minimize the possibility of customer confusion, Norwest has committed that it will make certain disclosures conspicuously in all sales literature provided to bank customers either through

[2] 75 Federal Reserve Bulletin 192 (1989), aff'd sub nom. Securities Industry Ass'n v. Board of Governors of the Federal Reserve System, 900 F.2d 360 (D.C. Cir. 1990).

[3] See Chemical Banking Corporation, 80 Federal Reserve Bulletin 49 (1994).

2185.0.13 APPENDIX G—LETTERS MODIFYING CONDITIONS—Continued

the mail or during educational seminars.[4] These disclosures also will be made orally and in writing at the beginning of educational seminars.

In order to address the potential conflicts of interest that could arise from activities that concern the family of funds ("Norwest Funds") advised by Norwest Bank Minnesota, N.A. ("Norwest Bank") and brokered, but not underwritten, by Company, Norwest has committed that if Norwest Funds is mentioned in materials provided to bank customers or during educational seminars, then Norwest will disclose that Norwest Bank is the investment adviser for Norwest Funds, and that a detailed description of the fees received by Norwest Bank for performing these services can be found in the applicable prospectus. In addition, if a particular mutual fund advised by Norwest Bank is mentioned in materials provided to bank customers or during educational seminars, bank customers will be informed of the particular fee arrangement between Norwest Bank and the mutual fund.

Norwest also has made several commitments that address conflicts of interest and customer confusion that could arise when Company employees who participate in educational seminars sponsored or co-sponsored by Norwest's subsidiary banks market bank-ineligible securities underwritten or dealt in by Company. Norwest has committed that at the beginning of educational seminars, seminar attendees will be told which seminar participants are Company employees and which are bank employees. Norwest also has committed that before bank-ineligible securities underwritten or dealt in by Company are marketed by Company employees, seminar attendees will be informed that such securities are underwritten or dealt in by Company and not by the bank.

Norwest has made several commitments to ensure that Norwest's subsidiary banks will not have any control over Company. Norwest has committed that there will be no employees in common between Company and any of its bank affiliates or their subsidiaries; and Company will remain

[4] Norwest has committed to disclose that products offered by Company are not FDIC insured, and are subject to investment risk, including the possible loss of the principal amount invested; investment products offered by Company are not deposits or other obligations of, or guaranteed by, the depository institution; Company is not a bank, and is separate from any affiliated bank; and Company is solely responsible for its contractual obligations and commitments.

2185.0.13 APPENDIX G—LETTERS MODIFYING CONDITIONS—Continued

separately incorporated, capitalized, and funded, and will be operationally distinct from its bank affiliates. In addition, Norwest has committed that all services performed by Norwest's subsidiary banks on behalf of Company will be conducted in accordance with section 23B of the Federal Reserve Act.

Based on all the facts of record, including those commitments made by Norwest in connection with this request, Norwest's subsidiary banks may engage in the proposed cross-marketing activities consistent with the commitment made to the Board by Norwest in connection with its application to underwrite and deal in, to a limited extent, certain bank-ineligible securities. This determination is limited to the specified practices and does not permit any other types of joint marketing, advertising or selling practices between Company and its affiliated banks.

Very truly yours,

[SIGNATURE]
William W. Wiles
Secretary of the Board

cc: Federal Reserve Bank of Minneapolis

Targeted examinations and investigations by the Federal Reserve and the Enforcement Division of the Securities Exchange Commission (SEC), as well as court actions, have found banks in violation of Regulation U, Credit by Banks for the Purpose of Purchasing or Carrying Margin Stock, (12 C.F.R. 221) when their trust departments, using bank or other fiduciary funds, have extended credit to individuals involved in illegal day trading or free-riding schemes. These activities also involved the aiding and abetting of violations of two other securities credit regulations: Regulation T, Credit by Brokers and Dealers (12 C.F.R. 220), and Regulation X, Borrowers of Securities Credit, (12 C.F.R. 224).

Day trading and free-riding schemes involve the purchase and sale of stock on the same day (or within a very short period of time) and the funding of the purchases with the proceeds of the sale. Banking organizations[1] engaging in such illegal activities may subject themselves to disciplinary proceedings, as well as to substantial credit risk.

Federal Reserve examiners should ensure that banks and bank holding companies (including the broker-dealer and trust activities of banking and nonbanking subsidiaries of state member banks and bank holding companies) are not engaged in such illegal activities. Examiners must make certain that these entities have taken all steps necessary to prevent their customers from involving them in free-riding. Prompt enforcement action may be needed to eliminate free-riding activities. (See SR-93-13.)

2187.0.1 TYPICAL DAY TRADING OR FREE-RIDING ACTIVITIES

The free-riding conduct in question typically involves trading large amounts of securities without depositing the necessary money or appropriate collateral in their customer accounts. The customer seeks to free-ride, that is, purchase and sell the same securities and pay for the purchase with the proceeds of the sale. Often, free-riding schemes involve initial public offerings because broker-dealers are prohibited from financing these new issues. If the money to pay for the securities is not in the account when the securities are delivered in a delivery-versus-payment (DVP) transaction, a bank that permits completion of the transaction creates a temporary overdraft in the customer's account. This overdraft is an extension of credit that subjects the banks to Regulation U.

The typical free-riding scheme involves a new customer's opening a custodial agency account into which a number of broker-dealers will deliver securities or funds in DVP transactions. Although a deposit may be made into the custodial agency account, the amount of trading is greatly in excess of the original deposit, causing the financial institution to extend its own credit to meet the payment and delivery obligations of the account. Therefore, although the financial institution may be earning fees as a result of the activity in these accounts, it is subjecting itself to substantial losses if the market prices for the purchased securities fall or the transactions otherwise fail. In addition, other liabilities under federal banking and securities laws may be involved.

2187.0.2 SECURITIES CREDIT REGULATIONS

2187.0.2.1 Regulation U, Credit by Banks or Persons Other Than Brokers or Dealers for the Purpose of Purchasing or Carrying Margin Stocks

Any extension of credit in the course of settling customer securities transactions, including those occuring in a trust department or trust subsidiary of a bank holding company, must comply with all of the provisions of Regulation U.[2] Regulation U requires all extensions of credit for the purpose of buying or carrying margin

1. The use of the term ''banking organization'' in this section, with regard to Regulation U, means a bank, trust department of a bank, or trust company of a bank holding company that is subject to Regulation U. Regulation U includes any nondealer nonbank subsidiary of a bank holding company that extends purpose credit by margin stock. With regard to Regulation T, it refers to any nonbank company that conducts broker-dealer activities.

2. For purposes of the regulation, the definition of ''bank'' specifically includes institutions ''exercising fiduciary powers.'' (See 12 C.F.R. 221.2, 15 U.S.C. 78(c)(a)(6), and *Federal Reserve Regulatory Service* at 5–795 (1946).) When used in discussing a bank's trust department or any other type of financial institution exercising fiduciary powers, the term ''extension of credit'' includes overdrafts in settling customer's accounts that may be covered by advances from the banking organization, from other fiduciary customers, or from a combination of both.

stock that are secured by margin stock to be within the 50 percent limit. To avoid violations of the Board's securities credit regulations, on settlement date, the customer's account must hold sufficient funds, excluding the proceeds of the sale of the security, to pay for each security purchased. Although Regulation U applies only to transactions in margin stock, free-riding in nonmargin stocks in custodial agency accounts could result in a banking organization's aiding and abetting violations of Regulations T and X and other securities laws, and could raise financial safety-and-soundness issues.

2187.0.2.2 Regulation T, Credit by Brokers and Dealers, and Regulation X, Borrowers of Securities Credit

Because the custodial agency accounts are used to settle transactions effected by the customer at broker-dealers, a banking organization that opens this type of account should have some general understanding of how Regulation T restricts the customer's use of the account at the institution. Regulation T requires the use of a cash account for customer purchases or sales on a DVP basis. Section 220.8(a) of Regulation T specifies that cash-account transactions are predicated on the customer's agreement that the customer will make full cash payment for securities before selling them and does not intend to sell them before making such payment. Therefore, free-riding is prohibited in a cash account. A customer who instructs his or her agent financial institution to pay for a security by relying on the proceeds of the sale of that security in a DVP transaction is causing, or aiding or abetting, the broker-dealer to violate the credit restrictions of Regulation T. Regulation X, which generally prohibits borrowers from willfully causing credit to be extended in violation of Regulations T or U, also applies to the customer in such cases.

As described above, banking organizations[3] involved in customer free-riding schemes may be aiding and abetting violations of Regulation T by the broker-dealers who deliver securities or funds to the banking organization's customers' accounts. As long as a financial institution uses its funds to complete a customer's transactions, broker-dealers may not discover that they are selling securities to the customer in violation of Regulation T. A similar aiding and abetting violation of Regulation X could occur if a customer used the financial institution to induce a broker-dealer to violate Regulation T.

2187.0.3 NEW-CUSTOMER INQUIRIES AND WARNING SIGNALS

Examiners should make certain that all banks and other financial-institution subsidiaries of a bank holding company are administering and following appropriate written policies and procedures concerning the establishment of custodial agency accounts or any new account involving customer securities transactions. Such policies and procedures should address, among other things, ways an institution can protect itself against free-riding schemes. One way is to obtain adequate background and credit information from new clients, including whether the customer intends to obtain credit to use with the account. This type of activity requires more extensive monitoring than the typical DVP account in which no credit is extended. It would be prudent to inquire why a new customer is not using the margin-account services of its broker-dealers. If the account is to be used as a margin account, a financial institution must obtain Form FR U-1 from the customer and must sign and constantly update the form.

The financial institution should obtain from the customer a list of broker-dealers that will be sending securities to or receiving funds from the account in DVP transactions. If a number of broker-dealers may be used, the institution should obtain from the customer a written statement that all transactions with the broker-dealer will conform with Regulations T and X and that the customer is aware that a security purchased in a cash account is not to be sold until it is paid for. Similarly, when obtaining instructions for settling DVP transactions for a customer, the financial institution should clarify that it will not rely upon the proceeds from the sale of those securities to pay for the purchase of the same securities.

2187.0.4 SCOPE OF THE INSPECTION FOR FREE-RIDING ACTIVITIES

Examiners, bank holding companies, state member banks, and financial-institution and trust subsidiaries owned by bank holding companies (also U.S. branches and agencies of foreign

3. For a discussion of Regulation T as it applies to a bank holding company's broker-dealer nonbank subsidiary, see section 3230.0.

banks exercising trust powers) should ensure that their banking organizations monitor accounts closely for an initial period to detect patterns typical of free-riding, including intraday overdrafts, and to ensure that sufficient funds or margin collateral are on deposit at all times. Frequent transactions in securities being offered in an initial public offering may suggest an avoidance of Regulations T and X. If it appears that a customer is attempting to free-ride, the financial institution should immediately alert the broker-dealers involved in transferring securities and take steps to minimize its own credit risk and legal liability.

At a minimum, examiners should also evaluate a trust institution's ability to ensure that it does not extend to a customer more credit on behalf of a bank or other financial institution than is permitted under Regulation U. If there are any questions in this regard, examiners should consult with their Reserve Bank's trust examiners. Any overdraft that is related to a purchase or sale of margin stock, and that is secured by margin stock, is an extension of credit subject to the regulation, including overdrafts that are outstanding for less than a day. Board staff have published a number of opinions discussing the application of Regulation U to various transactions relating to free-riding.

Free-riding violations that could endanger the banking organization (for example, fraudulent activities that could subject the organization to losses or lawsuits), as well as significant violations that were previously noted but have not yet been corrected, should be noted in the inspection report. Violations of the Board's Regulation T, U, or X, as applicable to the inspection, should be reported on the Examiner's Comments and Violations report pages. The report should discuss what action has or will be taken to correct those violations.

2187.0.5 SEC AND FEDERAL RESERVE SANCTIONS AND ENFORCEMENT ACTIONS

The SEC, in exercising its broad authority to enforce the Board's securities credit regulations, requires banks to (1) establish credit compliance committees to formulate written policies and procedures concerning the extension of purpose credit in their securities-clearance business, (2) establish training programs for bank personnel responsible for the conduct of their securities-clearance business, and (3) submit to outside audits to verify their compliance with the conditions of injunctions. The Board may also institute enforcement proceedings against the banking organizations it supervises and against any institution-affiliated parties involved in these activities, including cease-and-desist orders, civil money penalty assessments, and removal and permanent-prohibition actions.

2187.0.6 INSPECTION OBJECTIVES

1. To make certain that policies of the bank holding company's board, and the supervisory operating procedures, internal controls, and audit procedures will ensure, in the course of settling customers' securities transactions—
   a. that bank extensions of credit within the holding company comply with the provisions of Regulation U (including the requirement that initial extensions of credit that are secured by margin stock are within the initial 50 percent margin limit) and
   b. that customer accounts hold sufficient funds on the settlement date for each security purchased.
2. To determine—
   a. whether the banking organizations of the bank holding company can adequately monitor compliance with Regulation U through systems of internal controls, training, and compliance procedures (i.e., use of credit compliance committees) that address free-riding activities within the "back-office function"[4] and
   b. whether noncompliance is properly reported.
3. To initiate corrective action when policies, practices, procedures, or internal controls are not sufficient to prevent free-riding schemes, and when violations of the Board's regulations have been noted by bank examiners or self-regulatory organizations.

2187.0.7 INSPECTION PROCEDURES

1. Review the bank holding company's board of directors' policies for its banking institution subsidiaries regarding supervisory operational policies, procedures, and internal controls for loans extended for the purpose

4. Refers to the movement of cash and securities relating to trades and to the processing and recording of trades. This process is also called the "securities-clearance cycle."

of buying or carrying margin stock and secured directly or indirectly by margin stock.
   a. Determine whether the policies require, for *each* extension of credit not specifically exempted under Regulation U, that a Form FR U-1 be executed and signed by the customer and accepted and signed by a duly authorized officer of the banking organization acting in good faith.
   b. Determine whether the policies limit extensions of credit to no more than the maximum allowed loan value of the collateral, as set by section 221.7 of Regulation U, and whether those policies require adherence to margin requirements.
2. Review the bank holding company's board of directors' credit policies and operating policies, internal controls, and internal audit procedures to determine if they provide adequate safeguards against customers' free-riding practices. In so doing—
   a. determine if new-customer accounts are required to be approved by appropriate personnel; and
   b. establish whether the bank holding company's credit-system policies require—
      - controlling securities positions and financial-instrument contracts that serve as collateral for loans;
      - monitoring established restrictions and limits placed on the amounts and types of transactions to be executed with each customer and the dollar amounts placed on unsettled trades;
      - obtaining appropriate documentation consisting of essential facts pertaining to each customer, and in particular, financial information evidencing the customer's ability to pay for ordered securities, repay extensions of credit, and meet other financial commitments;
      - monitoring the location of all collateral;
      - ensuring that there are no overdrawn margin accounts; and
      - monitoring the status of failed transactions for the purpose of detecting free-riding schemes.
3. Determine if the bank holding company's audit committee or its internal or external auditors are required to review a selected random sample of individual or custodial agency accounts for customer free-riding activities.

2187.0.8 LAWS, REGULATIONS, INTERPRETATIONS, AND ORDERS

Subject	*Laws* [1]	*Regulations* [2]	*Interpretations* [3]	*Orders*
Credit by brokers and dealers		220 (Reg. T)		
Regulation U, Credit by Banks or Persons Other Than Brokers or Dealers for the Purpose of Purchasing or Carrying Margin Stocks		221 (Reg. U)		
Purpose credit—delivery-versus-payment transactions			5–942.15, 5–942.18, 5–942.2, 5–942.21, 5–942.22	
Borrowers of securities credit		224 (Reg. X)		

1. 12 U.S.C., unless specifically stated otherwise.
2. 12 C.F.R., unless specifically stated otherwise.
3. *Federal Reserve Regulatory Service* reference.

Banking organizations have long been involved with asset-backed securities (ABSs), both as investors in such securities and as major participants in the securitization process. In recent years they have stepped up their involvement by increasing their participation in the long-established market for securities backed by residential mortgage loans and by expanding their securitizing activities to other types of assets, including credit card receivables, automobile loans, boat loans, commercial real estate loans, student loans, nonperforming loans, and lease receivables.

While the objectives of securitization may vary from one depository institution to another, there are essentially five benefits that can be derived from those transactions. First, the sale of assets may reduce regulatory costs. The removal of an asset from an institution's books reduces capital requirements and reserve requirements on deposits funding the asset. Second, securitization provides originators with an additional source of funding and liquidity. The process of securitization is basically taking an illiquid asset and converting it into a security with greater marketability. Securitized issues often carry a higher credit rating than that which the institution itself could normally obtain and consequently may provide a cheaper form of funding. Third, securitization may be used to reduce interest-rate risk by improving the depository institution's asset–liability mix. This is especially true if the institution has a large investment in fixed-rate, low-yield assets. Fourth, by removing assets, the institution enhances its return on equity and assets. Finally, the ability to sell these securities worldwide diversifies the institution's funding base, thereby reducing dependence on local economies.

It is appropriate for banking organizations to engage in securitization activities and to invest in ABSs, if they do so in a prudent manner. Nonetheless, these activities can significantly affect their overall risk exposure. It is therefore of great importance, particularly given the growth and expansion of such activities, for examiners to be fully informed about the fundamentals of the securitization process, the various risks that securitization and investing in ABSs can create for banking organizations, and procedures that should be followed in examining banks and inspecting bank holding companies in order to effectively assess their exposure to risk and management of that exposure.

To provide examiners with the information and guidance they need on asset securitization, the following instructions were developed for System use. The mechanics of securitization and related accounting issues are discussed and inspection guidelines, objectives, and procedures are provided.[1]

2190.0.1 AN OVERVIEW OF ASSET SECURITIZATION

In recent years the number of banks and bank holding companies (hereafter referred to as banking organizations) that have issued securities backed by their assets and that have acquired asset-backed securities as investments has increased markedly. The reason for this increase is that securitization activities can yield significant financial and operational benefits for banking organizations.

In its simplest form, asset securitization involves the selling of assets. The process first segregates generally illiquid assets into pools and transforms them into capital-market instruments. The payment of principal and interest on these instruments depends on the cash flows from the assets in the pool that underlies the new securities. The new securities may have denominations, cash flows, and other features that differ from the pooled assets, which make them more attractive to investors.

The federal government encouraged the securitization of residential mortgages. In 1970, the Government National Mortgage Association (GNMA) created the first publicly traded mortgage-backed security. Soon, the Federal National Mortgage Association (FNMA) and the Federal Home Loan Mortgage Corporation (FHLMC), both government-sponsored agencies, also developed mortgage-backed securities. The guarantees that these government or government-sponsored entities provide, which assure investors of the payment of principal and interest, have greatly facilitated the securitization of mortgage assets.

1. The Federal Reserve System has developed a three-volume set that contains educational material on the process of asset securitization and examination guidelines (see SR-90-16). The volumes are—
   a. An Introduction to Asset Securitization,
   b. Accounting Issues Relating to Asset Securitization, and
   c. Examination Guidelines for Asset Securitization.

2190.0.2 THE SECURITIZATION PROCESS

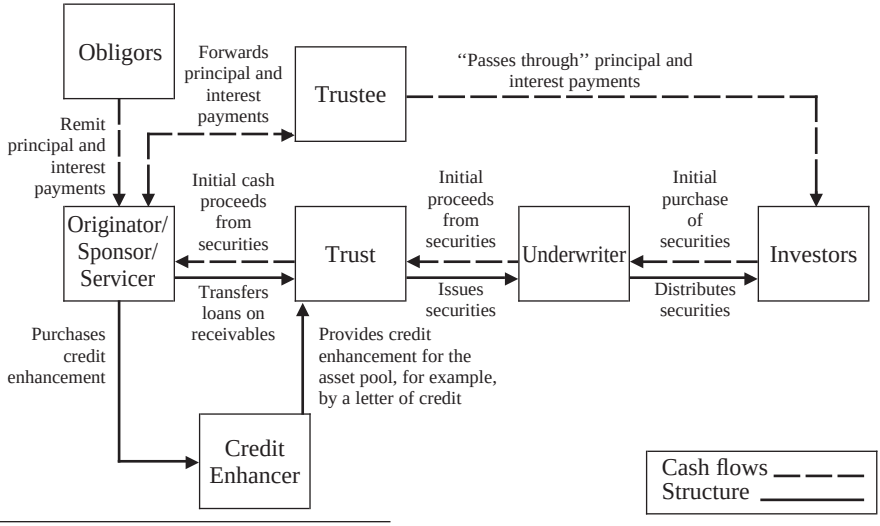
The asset-securitization process, as depicted in flow chart 1, begins with the segregation of loans or leases into pools that are relatively homogeneous with respect to credit, maturity, and interest-rate risks. These pools of assets are then transferred to a trust or other entity known as an issuer because it issues the securities or ownership interests that are acquired by investors. These asset-backed securities may take the form of debt, certificates of beneficial ownership, or other instruments. The issuer is typically protected from bankruptcy by various structural and legal arrangements. A sponsor that provides the assets to be securitized owns or otherwise establishes the issuer.

Each issue of asset-backed securities has a servicer responsible for collecting interest and principal payments on the loans or leases in the underlying pool of assets and for transmitting these funds to investors (or a trustee representing them). A trustee monitors the activities of servicers to ensure that they properly fulfill their role.

A guarantor may also be involved to see that investors receive principal and interest payments on a timely basis, even if the servicer does not collect these payments from the obligors. Many issues of mortgage-backed securities are either directly guaranteed by GNMA, a government agency backed by the full faith and credit of the U.S. government, or are guaranteed by FNMA or FHLMC, which are government-sponsored agencies that are perceived by the credit markets to have the implicit support of the federal government. Privately issued, mortgage-backed securities and other types of asset-backed securities generally depend on some form of credit enhancement provided by the originator or third party to insulate the investor from some or all of any credit losses. Usually, credit enhancement is provided for several multiples of the historical losses experienced on the particular asset backing the security.

One form of credit enhancement is the recourse provision, or guarantee, that requires the originator to cover any losses up to an amount contractually agreed upon. Some asset-backed securities, such as those backed by credit card receivables, typically use a ‘‘spread account,’’ which is actually an escrow account. The funds in this account are derived from a portion of the spread between the interest earned on the assets in the underlying pool and the lower interest paid on securities issued by the trust. The amounts that accumulate in the account are used to cover credit losses in the underlying asset pool up to several multiples of

Flow Chart 1
Pass-through, asset-backed securities: structure and cash flows



historical losses on the particular asset collateralizing the securities.

Overcollateralization, another form of credit enhancement covering a predetermined amount of potential credit losses, occurs when the value of the underlying assets exceeds the face value of the securities. Also, the senior subordinated security structure provides credit enhancement, generally to the senior class. Under such a structure, at least two classes of asset-backed securities are issued, with the senior class having a priority claim on the cash flows from the underlying pool of assets. Therefore, the subordinated class must absorb credit losses before any are charged to the senior portion. Because the senior class has this priority claim, cash flows from the underlying pool of assets must first satisfy the requirements of the senior class. Only after these requirements have been met will the cash flows be directed to service the subordinated class. Other forms of credit enhancement include standby letters of credit or surety bonds from third parties.

An investment banking firm or other organization generally serves as an underwriter for asset-backed securities. In addition, for asset-backed issues that are publicly offered, a credit rating agency will analyze the policies and operations of the originator and servicer, as well as the structure, underlying pool of assets, expected cash flows, and other attributes of such securities. Before assigning a rating to the issue, the rating agency will also assess the extent of loss protection provided to investors by the credit enhancements associated with the issue.

Traditional lending activities are generally funded by deposits or other liabilities, and both the assets and related liabilities are reflected on the balance sheet. Deposit liabilities must generally increase in order to fund additional loans.

In contrast, the securitization process generally does not increase on-balance-sheet liabilities in proportion to the volume of loans or other assets securitized. As discussed more fully below, when banking organizations securitize their assets and these transactions are treated as sales, both the assets and the related asset-backed securities (i.e., liabilities) are removed from the balance sheet. The cash proceeds from the securitization transactions are generally used to originate or acquire additional loans or other assets for securitization and the process is repeated. Thus, for the same volume of loan originations, securitization, in comparison to traditional lending activities, results in lower assets and liabilities.

2190.0.3 THE STRUCTURE OF ASSET-BACKED SECURITIES

Asset securitization involves different kinds of capital-market instruments. These instruments may be structured as ''pass-throughs'' or ''pay-throughs.'' Under a pass-through structure, the cash flows from the underlying pool of assets are passed through to investors on a pro rata basis. This type of security is typically a single-class instrument such as a GNMA pass-through. The pay-through structure, with multiple classes, combines the cash flows from the underlying pool of assets and reallocates them to two or more issues of securities that have different cash-flow characteristics and maturities. An example is the collateralized mortgage obligation (CMO), which has a series of bond classes, each with its own specified coupon and stated maturity. In most cases, the assets that make up the CMO collateral pools are pass-through securities. Scheduled principal payments, and any prepayments, from the underlying collateral go first to the earliest maturing class of bonds. This first class of bonds must be retired before the principal cash flows are used to retire the later bond classes. The development of the pay-through structure resulted from the desire to broaden the marketability of these securities to investors who were interested in maturities other than those generally associated with pass-through securities.

Multiple-class asset-backed securities may also be issued as derivative instruments such as ''stripped'' securities. Investors in each class of a stripped security will receive a different portion of the principal and interest cash flows from the underlying pool of assets. In their purest form, stripped securities may be issued as *interest-only (IO) strips*, for which the investor receives 100 percent of the interest from the underlying pool of assets, and as *principal-only (PO) strips*, for which the investor receives all of the principal.

In addition to these securities, other types of financial instruments may arise as a result of asset securitization. One such instrument is loan-servicing rights that are created when organizations purchase the right to act as servicers for pools of loans. The cost of these purchased servicing rights may be recorded as an intangible asset when certain criteria are met. Another financial instrument, excess servicing-fee receivables, generally arise when the present value of any additional cash flows from the underlying

assets that a servicer expects to receive exceeds standard normal servicing fees. Another instrument, asset-backed securities residuals (sometimes referred to as ''residuals'' or ''residual interests''), represents claims on any cash flows that remain after all obligations to investors and any related expenses have been met. Such excess cash flows may arise as a result of overcollateralization or from reinvestment income. Residuals can be retained by sponsors or purchased by investors in the form of securities.

2190.0.4 SUPERVISORY CONSIDERATIONS REGARDING ASSET SECURITIZATION

Although banking organizations clearly benefit from engaging in securitization activities and investing in asset-backed securities, these activities, if not conducted prudently, can increase a banking organization's overall risk profile. For the most part, the risks that financial institutions encounter in the securitization process are identical to those that they face in traditional lending transactions. These involve credit risk, concentration risk, and interest-rate risk—including prepayment risk, operational risk, liquidity risk, and funding risk. However, since the securitization process separates the traditional lending function into several limited roles such as originator, servicer, credit enhancer, trustee, and investor, the types of risks that a bank will encounter will differ depending on the role it assumes.

Investors who invest in asset-backed securities, like investors who invest directly in the underlying assets, will be exposed to credit risk, that is, the risk that obligors will default on principal and interest payments. Investors are also subject to the risk that the various parties in the securitization structure, for example, the servicer or trustee, will be unable to fulfill their contractual obligations. Moreover, investors may be susceptible to concentrations of risks across various asset-backed security issues through overexposure to an organization performing various roles in the securitization process or as a result of geographic concentrations within the pool of assets providing the cash flows for an individual issue. Also, because the secondary markets for certain asset-backed securities are thin, investors may encounter greater than anticipated difficulties when seeking to sell their securities. Furthermore, certain derivative instruments, such as stripped asset-backed securities and residuals, may be extremely sensitive to interest rates and exhibit a high degree of price volatility, and, therefore, may dramatically affect the risk exposure of investors unless used in a properly structured hedging strategy.

Banking organizations that issue asset-backed securities may be subject to pressures to sell only their best assets, thus reducing the quality of their own loan portfolios. On the other hand, some banking organizations may feel pressures to relax their credit standards because they can sell assets with higher risk than they would normally want to retain for their own portfolios.

Banking organizations that service securitization issues must ensure that their policies, operations, and systems will not permit breakdowns that may lead to defaults. Issuers and servicers may face pressures to provide ''moral recourse'' by repurchasing securities backed by loans or leases that they have originated that have deteriorated and become nonperforming. Funding risk may also be a problem for issuers when market aberrations do not permit the issuance of asset-backed securities that are in the securitization pipeline.

Asset securitization transactions are frequently structured to obtain certain accounting treatments, which, in turn, affect reported measures of profitability and capital adequacy. In transferring assets into a pool to serve as collateral for asset-backed securities, a key question is whether the transfer should be treated as a sale of the assets or as a collateralized borrowing, that is, a financing transaction secured by assets. Sales treatment results in the assets being removed from the banking organization's balance sheet, thus reducing total assets relative to earnings and capital, thereby producing higher performance and capital ratios. Treatment of these transactions as financings, however, means that the assets in the pool remain on the balance sheet and are subject to capital requirements and the related liabilities to reserve requirements.[2]

2190.0.5 POLICY STATEMENT ON INVESTMENT SECURITIES AND END-USER DERIVATIVES ACTIVITIES

On April 23, 1998, the FFIEC issued a State-

2. Note, however, that it is the Federal Reserve's Regulation D that defines what constitutes a reservable liability of a depository institution. Thus, although a given transaction may qualify as an asset sale for call report purposes, it nevertheless could result in a reservable liability under Regulation D.

ment on Investment Securities and End-User Derivatives Activities, effective May 25, 1998. The statement was adopted by the Board of Governors and also the other federal financial institutions regulatory agencies. It provides guidance on sound practices for managing the risks of investment activities, focusing on sound risk-management practices that should be used by state member banks and Edge corporations. The basic principles also apply to bank holding companies, which should manage and control risk exposures on a consolidated basis, giving recognition to the legal distinctions and potential obstacles to cash movements among subsidiaries.

The statement's principles set forth risk-management practices that are relevant to most portfolio-management endeavors. The statement places greater emphasis on a risk-focused approach to supervision. Instruments held for end-user reasons are considered, taking into consideration a variety of factors such as management's ability to manage and measure risk within the institution's holdings and the impact of those holdings on aggregate portfolio risk. See section 2126.1 and SR-98-12.[3]

2190.0.5.1 Mortgage-Derivative Products

Mortgage-derivative products include instruments such as collateralized mortgage obligations (CMOs), real estate mortgage investment conduits (REMICs), stripped mortgage-backed securities (SMBSs), and CMO and REMIC residuals. Supervisory concerns about these instruments arise from their extreme sensitivity to interest rates and the resulting price volatility. This price volatility is caused in part by the uncertain cash flows that result from changes in the prepayment rates of the underlying mortgages. Institutions that purchase such high-risk mortgage-derivative securities need to understand and effectively manage the associated risks. The levels of activity in such products should reasonably be related to the institution's capital, capacity to absorb losses, and level of in-house management sophistication and expertise. Appropriate managerial and financial controls need to be in place, and the institution must analyze, monitor, and prudently adjust its holdings of high-risk mortgage securities in an environment of changing price and maturity expectations.

Before an institution takes a position in any high-risk mortgage security, management should conduct an analysis to ensure that the position will reduce the institution's overall interest-rate risk. It should also consider the liquidity and price volatility of these products before their purchase.

CMOs and REMICs were developed in response to investors' concerns about the uncertainty of cash flows associated with the prepayment option of the underlying mortgagor. These securities can be collateralized directly by mortgages, but more often they are collateralized by mortgage-backed securities issued or guaranteed by the Government National Mortgage Association (GNMA), the Federal National Mortgage Association (FNMA), or the Federal Home Loan Mortgage Corporation (FHLMC) and held in trust for investors. The cash flow from the underlying mortgages is segmented and paid in accordance with a predetermined priority to investors holding various tranches. By allocating the principal and interest cash flows from the underlying collateral among the separate CMO tranches, different classes of bonds are created, each with its own stated maturity, estimated average life, coupon rate, and prepayment characteristics. It is essential to understand the coupon rates of the underlying mortgages of the CMO or REMIC in order to assess the prepayment sensitivity of the CMO tranches.

SMBSs consist of two classes of securities, with each class receiving a different portion of the monthly interest and principal cash flows from the underlying mortgage-backed securities (MBSs). An SMB, in its purest form, is converted into an interest-only (IO) strip, where the investor receives all of the interest cash flows and none of the principal. An investor owning a principal-only (PO) strip receives all of the principal cash flows and none of the interest. IOs and POs have highly volatile price characteristics based, in part, on the prepayment variability of the underlying mortgages. Generally, POs increase in value when interest rates decline, in part because prepayments shorten the maturity of mortgages. In contrast, IOs and residuals tend to increase in value when interest rates rise because prepayments decline, maturities lengthen, and more interest is collected on the underlying mortgages.

When purchasing an IO, PO, or residual, without offsetting hedges, the investor may be speculating on future interest-rate movements

3. The supervisory policy statement on Investment Securities and End-User Derivatives Activities is in the *Federal Reserve Regulatory Service* at 3–1562.

and how these movements will affect the prepayment of the underlying collateral. Furthermore, stripped mortgage-backed securities that do not have a government agency's or a government-sponsored agency's guarantee of principal and interest have an added element of credit risk. The policy statement discusses the appropriateness of these instruments for depository institutions and the prudential measures that a depository institution should take to protect itself from undue risk when investing in them.

Residuals represent claims on any cash flows from a CMO issue or other asset-backed security remaining after the payments to the holders of the other classes have been made and after trust-administration expenses are met. The economic value of a residual is a function of the present value of the anticipated cash flows.

2190.0.6 RISK-BASED CAPITAL PROVISIONS AFFECTING ASSET SECURITIZATION

The risk-based capital framework has three main features that will affect the asset-securitization activities of banking organizations. First, the framework assigns risk weights to loans, asset-backed securities, and other assets related to securitization. Second, bank holding companies that transfer assets with recourse to the seller as part of the securitization process will now explicitly be required to hold capital against their off-balance-sheet credit exposures. Third, banking organizations that provide credit enhancement to asset-securitization issues through standby letters of credit or by other means will have to hold capital against the related off-balance-sheet credit exposure.

The risk weights assigned to an asset-backed security depend on the issuer and whether the assets that comprise the collateral pool are mortgage-related assets. Asset-backed securities issued by a trust or by a single-purpose corporation and backed by nonmortgage assets are to be assigned a risk weight of 100 percent.

Securities guaranteed by U.S. government agencies and those issued by U.S. government–sponsored agencies are assigned risk weights of 0 and 20 percent, respectively, because of the low degree of credit risk. Accordingly, mortgage pass-through securities guaranteed by GNMA are placed in the risk category of 0 percent. In addition, securities such as participation certificates and CMOs issued by FNMA or FHLMC are assigned a 20 percent risk weight.

However, several types of securities issued by FNMA and FHLMC are excluded from the lower risk weight and slotted in the 100 percent risk category. Residual interests (for example, CMO residuals) and subordinated classes of pass-through securities or CMOs that absorb more than their pro rata share of loss are assigned to the 100 percent risk-weight category. Furthermore, all stripped mortgage-backed securities, including IOs, POs, and similar instruments, are also assigned to the 100 percent risk-weight category because of their extreme price volatility and market risk. The treatment of stripped mortgage-backed securities will be reconsidered when a method to measure interest-rate risk is incorporated into the risk-based capital guidelines.

A privately issued, mortgage-backed security that meets the criteria listed below is considered as a direct or indirect holding of the underlying mortgage-related assets and is assigned to the same risk category as those assets (for example, U.S. government agency securities, U.S. government–sponsored agency securities, FHA- and VA-guaranteed mortgages, and conventional mortgages). However, under no circumstances will a privately issued mortgage-backed security be assigned to the 0 percent risk category. Therefore, private issues that are backed by GNMA securities will be assigned to the 20 percent risk category as opposed to the 0 percent category appropriate to the underlying GNMA securities. Following are the criteria that a privately issued mortgage-backed security must meet to be assigned the same risk weight as the underlying assets:

1. The underlying assets are held by an independent trustee, and the trustee has a first-priority, perfected security interest in the underlying assets on behalf of the holders of the security.
2. The holder of the security has an undivided pro rata ownership interest in the underlying mortgage assets, or the trust or single-purpose entity (or conduit) that issues the

security has no liabilities unrelated to the issued securities.
3. The cash flow from the underlying assets of the security in all cases fully meets the cash-flow requirements of the security without undue reliance on any reinvestment income.
4. No material reinvestment risk is associated with any funds awaiting distribution to the holders of the security.

Those privately issued mortgage-backed securities that do not meet the above criteria are to be assigned to the 100 percent risk category.

If the underlying pool of mortgage-related assets is composed of more than one type of asset, then the entire class of mortgage-backed securities is assigned to the category appropriate to the highest risk-weighted asset in the asset pool. For example, if the security is backed by a pool consisting of U.S. government–sponsored agency securities (for example, FHLMC participation certificates) that qualify for a 20 percent risk weight and conventional mortgage loans that qualify for the 50 percent risk category, then it would receive the 50 percent risk weight.

As previously mentioned, bank holding companies report their activities in accordance with GAAP, which permits asset-securitization transactions to be treated as sales when certain criteria are met, even when there is recourse to the seller. With the advent of risk-based capital, bank holding companies will be explicitly required to hold capital against the off-balance-sheet credit exposure arising from the contingent liability associated with the recourse provisions. This exposure is considered a direct credit substitute that would be converted at 100 percent to an on-balance-sheet credit-equivalent amount for appropriate risk weighting.

Banking organizations that issue standby letters of credit for asset-backed security issues, as credit enhancements, must hold capital against these contingent liabilities under the risk-based capital guidelines. According to the guidelines, financial standby letters of credit are direct credit substitutes, which are converted in their entirety to credit-equivalent amounts. The credit-equivalent amounts are then risk weighted according to the type of counterparty or, if relevant, to any guarantee or collateral.

2190.0.7 UNDERWRITING AND DEALING IN SECURITIES

Member banks may underwrite and deal in obligations of the United States, general obligations of states and political subdivisions, and certain securities issued or guaranteed by government agencies (12 U.S.C. 335 and 12 U.S.C. 24 (Seventh)). Bank holding companies may underwrite and deal in U.S. government and agency and state and municipal securities and other obligations that state member banks are authorized to underwrite and deal in under section 16 of the Glass-Steagall Act (referred to as ''eligible-securities''), as authorized by section 225.28(b)(8) of Regulation Y. By Board order, beginning in 1987, certain bank holding company nonbanking subsidiaries were given the authority to underwrite and deal in ''ineligible securities'' that member banks may not underwrite and deal in, specifically—

1. municipal revenue bonds, including ''public-ownership'' industrial-development bonds (tax-exempt bonds in which the governmental issuer, or the government unit on behalf of which the bonds are issued, is the owner, for federal income tax purposes, of the financed facility—such as airports, mass transportation facilities, and water pollution control facilities);
2. mortgage-related securities (obligations secured by or representing an interest in one- to four-family residential real estate);
3. consumer receivable–related securities; and
4. ''prime quality'' commercial paper.

In January 1989, certain bank holding companies having section 20 nonbanking subsidiaries were also approved to underwrite and deal in debt or equity securities (excluding open-end investment companies). The Board, however, required that each applicant establish the necessary managerial and operational infrastructure before receiving Board authorization to commence the expanded underwriting and dealing activity. All bank holding companies having section 20 Board orders are subject to specific conditions (''firewalls'') as stated within their respective Board orders.

On September 21, 1989, the Board approved by order (1989 FRB 751) the ability of bank holding company subsidiaries to underwrite and deal in securities of affiliates, consistent with section 20 of the Glass-Steagall Act, if the securities—

1. are rated by an unaffiliated, nationally recognized statistical rating organization or
2. are issued or guaranteed by the Federal National Mortgage Association (FNMA), the Federal Home Loan Mortgage Corporation (FHLMC), or the Government National

Mortgage Association (GNMA), or represent interests in such obligations.

For a more detailed description of underwriting and dealing in bank-ineligible securities, see section 2185.0.

The securitization power of national banks was reaffirmed on February 20, 1990, when the Supreme Court let stand a court of appeals ruling that permits national banks to package and sell mortgage loans as securities. The ruling confirms that they not only can sell but can also underwrite mortgage-backed securities from mortgage loans that they originate (*Securities Industry Association* v. *Clarke*, 885 F.2d 1034 (2d Cir. 1989), *cert. denied*, 110 S.Ct. 1113).

2190.0.8 INSPECTION OBJECTIVES

1. To determine that securitization activities are integrated into the overall strategic objectives of the organization.
2. To determine that sources of credit risk are understood, and properly analyzed and managed, without excessive reliance on credit ratings by outside agencies.
3. To determine that credit, operational, and other risks are recognized and are addressed through appropriate policies, procedures, management reports, and other controls.
4. To determine that liquidity and market risks are recognized and that the organization is not excessively dependent on securitization as a substitute for funding or as a source of income.
5. To determine that steps have been taken to minimize the potential for conflicts of interest due to securitization.
6. To determine that possible sources of structural failure in securitization transactions are recognized and that the organization has adopted measures to minimize the impact of such failures if they occur.
7. To determine that the organization is aware of the legal risks and uncertainty regarding various aspects of securitization.
8. To determine that concentrations of exposure in the underlying asset pools, in the asset-backed securities portfolio, or in the structural elements of securitization transactions, are avoided.
9. To determine that all sources of risk are evaluated at the inception of each securitization activity and are monitored on an ongoing basis.

2190.0.9 INSPECTION PROCEDURES

1. Review the parent company's policies and procedures to ensure that its banking and nonbanking subsidiaries follow prudent standards of credit assessment and approval for all securitization exposure. Procedures should include thorough and independent credit assessment of each loan or pool for which it has assumed credit risk, followed by periodic credit reviews to monitor performance throughout the life of the exposure. If a banking organization invests in asset-backed securities, determine whether there is sole reliance on conclusions of external rating services when evaluating the securities.
2. Determine that rigorous credit standards are applied regardless of the role the organization plays in the securitization process, e.g., servicer, credit enhancer, or investor.
3. Determine that major policies and procedures, including internal credit-review and -approval procedures and "in-house" exposure limits, are reviewed periodically and approved by the bank holding company's board of directors.
4. Determine whether adequate procedures for evaluating the organization's internal control procedures and the financial strength of the other institutions involved in the securitization process are in place.
5. Obtain the documentation outlining the remedies available to provide credit enhancement in the event of a default. Also, both originators and purchasers of securitized assets have prospectuses on the issue. Obtaining a copy of the prospectus can be an invaluable source of information. Prospectuses generally contain information on credit enhancement, default provisions, subordination agreements, etc.
6. Ensure that, regardless of the role an institution plays in securitization, the documentation for an asset-backed security clearly specifies the limitations of the institution's legal responsibility to assume losses.
7. Verify whether the banking organization, acting as originator, packager, or underwriter, has written policies addressing the repurchase of assets and other reimbursement to investors in the event that a defaulted package results in losses exceeding any contractual credit enhancement. The repurchase of defaulted assets or pools in contradiction of the underlying agreement in effect sets a standard by which a banking organization could be found legally

liable for all ''sold'' assets. Review and report any situations in which the organization has repurchased or otherwise reimbursed investors for poor-quality assets.

8. Classify adverse credit risk associated with securitization of assets when analyzing the adequacy of an organization's capital or reserve levels. Adverse credit risk should be classified accordingly.
9. Aggregate securitization exposures with all loans, extensions of credit, debt and equity securities, legally binding financial guarantees and commitments, and any other investments involving the same obligor when determining compliance with internal credit exposure limits.
10. Review securitized assets for industrial or geographic concentrations. Excessive exposures to an industry or region among the underlying assets should be noted in the review of the loan portfolio.
11. Ensure that, in addition to policies limiting direct credit exposure, an institution has developed exposure limits with respect to particular originators, credit enhancers, trustees, and servicers.
12. Review the policies of the banking organization engaged in underwriting with regard to situations in which it cannot sell underwritten asset-backed securities. Credit review, funding capabilities, and approval limits should allow the institution to purchase and hold unsold securities. All potential credit exposure should be within legal lending limits.
13. Ensure that internal systems and controls adequately track the performance and condition of internal exposures and adequately monitor the organization's compliance with internal procedures and limits. In addition, adequate audit trails and internal audit coverage should be provided.
14. Determine that management information systems provide—
    a. a listing of all securitizations in which the organization is involved;
    b. a listing of industry and geographic concentration;
    c. information on total exposure to specific originators, servicers, credit enhancers, trustees, or underwriters;
    d. information regarding portfolio aging and performance relative to expectations; and
    e. periodic and timely information to senior management and directors on the organization's involvement in, and credit exposure arising from, securitization.
15. Ensure that internal auditors examine all facets of securitization regularly.
16. Review policies and procedures for compliance with applicable state lending limits and federal law such as section 5136 of the Revised Code. These requirements must be analyzed to determine whether a particular asset-backed security issue is considered a single investment or a loan to each of the creditors underlying the pool. Collateralized mortgage obligations may be exempt from this limitation if they are issued or guaranteed by an agency or instrumentality of the U.S. government.
17. Determine whether the underwriting of asset-backed securities of affiliates are—
    a. rated by an unaffiliated, nationally recognized statistical rating organization or
    b. issued or guaranteed by FNMA, FHLMC, or GNMA or represent interests in such obligations.
18. If the parent organization or any of its banking and nonbanking subsidiaries invests in high-risk mortgage-derivative securities, determine whether management effectively manages the associated risks commensurate with the level of activity.
    a. Determine whether the level of activity is reasonably related to the level of capital, the organization's ability to absorb losses, and the level of in-house management sophistication and expertise.
    b. Ascertain whether the appropriate managerial and financial controls are required to be in place, and whether the parent organization analyzes, monitors, and prudently adjusts holdings of such high-risk securities when an environment of changing price and maturity expectations exists. In that regard, determine to what extent the organization considers the liquidity and price volatility of the high-risk mortgage derivative products prior to their acquistion.

Subprime lending presents unique and significantly greater risk to banking organizations (BOs) associated with the activity,[1] raising issues about how well they are prepared to manage and control those risks. Subprime-lending institutions need strong risk-management practices and internal controls, as well as board-approved policies and procedures that appropriately identify, measure, monitor, and control all associated risks. BOs considering or engaging in this type of lending should recognize the additional risks inherent in this activity and determine if these risks are acceptable and controllable, given their organization's financial condition, asset size, level of capital support, and staff size.

In response to concerns about subprime lending, the statement ''Interagency Guidance on Subprime Lending,'' was issued on March 1, 1999.[2] The statement's objective is to increase awareness among examiners and financial institutions of some of the pitfalls and hazards of this type of lending and to provide general supervisory guidance on the topic. See SR-99-06. The statement is directed to insured depository institutions and their subsidiaries, which includes state member banks. As such, the guidance applies only indirectly to bank holding companies with regard to their supervision of insured depository institutions. Bank holding companies should also consider the statement's guidance as they supervise the lending activities of their nonbanking subsidiaries. Bank holding company examiners should consider this guidance in conjunction with the loan-administration and lending-standards inspection guidance in section 2010.2, and the guidance for asset securitization in section 2190.0. The text of the statement follows. (Section numbers have been added for reference, and some wording has been slightly altered to make the policy appropriate for this manual.)

2190.05.1 INTERAGENCY GUIDANCE ON SUBPRIME LENDING

Insured depository institutions have traditionally avoided lending to customers with poor credit histories because of the higher risk of default and resulting loan losses. However, in recent years a number of lenders[3] have extended their risk-selection standards to attract lower-credit-quality accounts, often referred to as subprime loans. Moreover, recent turmoil in the equity and asset-backed securities market has caused some nonbank subprime specialists to exit the market, thus creating increased opportunities for financial institutions to enter, or expand their participation in, the subprime-lending business

The term ''subprime lending'' is defined for this statement as extending credit to borrowers who exhibit characteristics indicating a significantly higher risk of default than traditional bank lending customers.[4] Risk of default may be measured by traditional credit-risk measures (credit/repayment history, debt-to-income levels, etc.) or by alternative measures such as credit scores. Subprime borrowers represent a broad spectrum of debtors ranging from those who have exhibited repayment problems due to an adverse event, such as job loss or medical emergency, to those who persistently mismanage their finances and debt obligations. Subprime lending does not include loans to borrowers who have had minor, temporary credit difficulties but are now current. This guidance applies to direct extensions of credit; the purchase of subprime loans from other lenders, including delinquent or credit-impaired loans purchased at a discount; the purchase of subprime automobile or other financing ''paper'' from lenders or dealers; and the purchase of loan companies that originate subprime loans.

Due to their higher risk, subprime loans command higher interest rates and loan fees than those offered to standard-risk borrowers. These loans can be profitable, provided the price charged by the lender is sufficient to cover higher loan-loss rates and overhead costs related to underwriting, servicing, and collecting the loans. Moreover, the ability to securitize and sell subprime portfolios at a profit while retaining the servicing rights has made subprime lending attractive to a larger number of institutions, further increasing the number of subprime lend-

1. The term ''banking organizations'' refers to bank holding companies and their banking and nonbanking subsidiaries.

2. The statement was adopted and issued by the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency, and the Office of Thrift Supervision.

3. The terms ''lenders,'' ''financial institutions,'' and ''institutions,'' . . . refer to insured depository institutions and their subsidiaries.

4. For purposes of this statement, loans to customers who are not subprime borrowers are referred to as ''prime.''

ers and loans. . . . [A] number of financial institutions have experienced losses attributable to ill-advised or poorly structured subprime-lending programs. This has brought greater supervisory attention to subprime lending and the ability of insured depository institutions to manage the unique risks associated with this activity.

Institutions should recognize the additional risks inherent in subprime lending and determine if these risks are acceptable and controllable given the institution's staff, financial condition, size, and level of capital support. Institutions that engage in subprime lending in any significant way should have board-approved policies and procedures, as well as internal controls that identify, measure, monitor, and control these additional risks. Institutions that engage in a small volume of subprime lending should have systems in place commensurate with their level of risk. Institutions that began a subprime-lending program prior to the issuance of this guidance should carefully consider whether their program meets the following guidelines and should implement corrective measures for any area that falls short of these minimum standards. If the risks associated with this activity are not properly controlled, the agencies consider subprime lending a high-risk activity that is unsafe and unsound.

2190.05.2 CAPITALIZATION

[S]ubprime-lending activities can present a greater-than-normal risk for financial institutions and the deposit insurance funds; therefore, the level of capital institutions need to support this activity should be commensurate with the additional risks incurred. The amount of additional capital necessary will vary according to the volume and type of subprime activities pursued and the adequacy of the institution's risk-management program. Institutions should determine how much additional capital they need to offset the additional risk taken in their subprime-lending activities and document the methodology used to determine this amount. The agencies will evaluate an institution's overall capital adequacy on a case-by-case basis through on-site examinations and off-site monitoring procedures considering, among other factors, the institution's own analysis of the capital needed to support subprime lending. Institutions determined to have insufficient capital must correct the deficiency within a reasonable timeframe or be subject to supervisory action. In light of the higher risks associated with this type of lending, . . . higher minimum-capital requirements [may be imposed] on institutions engaging in subprime lending.

2190.05.3 RISK MANAGEMENT

The following items are essential components of a well-structured risk-management program for subprime lenders:

1. *Planning and strategy.* Prior to engaging in subprime lending, the board and management should ensure that proposed activities are consistent with the institution's overall business strategy and risk tolerances, and that all involved parties have properly acknowledged and addressed critical business risk issues. These issues include the costs associated with attracting and retaining qualified personnel, investments in the technology necessary to manage a more complex portfolio, a clear solicitation and origination strategy that allows for after-the-fact assessment of underwriting performance, and the establishment of appropriate feedback and control systems. The risk-assessment process should extend beyond credit risk and appropriately incorporate operating, compliance, and legal risks. Finally, the planning process should set clear objectives for performance, including the identification and segmentation of target markets and/or customers, and performance expectations and benchmarks for each segment and the portfolio as a whole. Institutions establishing a subprime-lending program should proceed slowly and cautiously into this activity to minimize the impact of unforeseen personnel, technology, or internal control problems and to determine if favorable initial profitability estimates are realistic and sustainable.
2. *Staff expertise*. Subprime lending requires specialized knowledge and skills that many financial institutions may not possess. Marketing, account-origination, and collections strategies and techniques often differ from those employed for prime credit; thus it may not be sufficient to have the same lending staff responsible for both subprime loans and other loans. Additionally, servicing and collecting subprime loans can be very labor intensive. If necessary, the institution should implement programs to train staff. The board should ensure that staff possesses sufficient

expertise to appropriately manage the risks in subprime lending and that staffing levels are adequate for the planned volume of subprime activity. Seasoning of staff and loans should be taken into account as performance is assessed over time.

3. *Lending policy*. A subprime-lending policy should be appropriate to the size and complexity of the institution's operations and should clearly state the goals of the subprime-lending program. While not exhaustive, the following lending standards should be addressed in any subprime-lending policy:
   a. types of products offered as well as those that are not authorized
   b. portfolio targets and limits for each credit grade or class
   c. lending and investment authority clearly stated for individual officers, supervisors, and loan committees
   d. a framework for pricing decisions and profitability analysis that considers all costs associated with the loan, including origination costs, administrative/servicing costs, expected charge-offs, and capital
   e. collateral evaluation and appraisal standards
   f. well-defined and specific underwriting parameters (i.e., acceptable loan term, debt-to-income ratios, loan-to-collateral-value ratios for each credit grade, and minimum acceptable credit score) that are consistent with any applicable supervisory guidelines[5]
   g. procedures for separate tracking and monitoring of loans approved as exceptions to stated policy guidelines
   h. credit-file documentation requirements such as applications, offering sheets, loan and collateral documents, financial statements, credit reports, and credit memoranda to support the loan decision
   i. correspondent/broker/dealer approval process, including measures to ensure that loans originated through this process meet the institution's lending standards

   If the institution elects to use credit scoring (including applications scoring) for approvals or pricing, the scoring model should be based on a development population that captures the behavioral and credit characteristics of the subprime population targeted for the products offered. Because of the significant variance in characteristics between the subprime and prime populations, institutions should not rely on models developed solely for products offered to prime borrowers. Further, the model should be reviewed frequently and updated as necessary to ensure that assumptions remain valid.
4. *Purchase evaluation*. Institutions that purchase subprime loans from other lenders or dealers must give due consideration to the cost of servicing these assets and the loan losses that may be experienced as they evaluate expected profits. For instance, some lenders who sell subprime loans charge borrowers high up-front fees, which are usually financed into the loan. This provides incentive for originators to produce a high volume of loans with little emphasis on quality, to the detriment of a potential purchaser. Further, subprime loans, especially those purchased from outside the institution's lending area, are at special risk for fraud or misrepresentation (i.e., the quality of the loan may be less than the loan documents indicate).

   Institutions should perform a thorough due-diligence review prior to committing to purchase subprime loans. Institutions should not accept loans from originators that do not meet their underwriting criteria, and should regularly review loans offered to ensure that loans purchased continue to meet those criteria. Deterioration in the quality of purchased loans or in the portfolio's actual performance versus expectations requires a thorough reevaluation of the lenders or dealers who originated or sold the loans, as well as a reevaluation of the institution's criteria for underwriting loans and selecting dealers and lenders. Any such deterioration may also highlight the need to modify or terminate the correspondent relationship or make adjustments to underwriting and dealer/lender selection criteria.
5. *Loan-administration procedures*. After the loan is made or purchased, loan-administration procedures should provide for the diligent monitoring of loan performance and establish sound collection efforts. To minimize loan losses, successful subprime lenders have historically employed stronger

5. Extensions of credit secured by real estate, whether subprime or otherwise, are subject to the Interagency Guidelines for Real Estate Lending Policies, which establish supervisory loan-to-value (LTV) limits on various types of real estate loans and impose limits on an institution's aggregate investment in loans that exceed the supervisory LTV limits. See 12 C.F.R. 34, subpart D (OCC); 12 C.F.R. 208, appendix C (FRB); 12 C.F.R. 365 (FDIC); and 12 C.F.R. 560.100–101 (OTS) for further information.

collection efforts such as calling delinquent borrowers frequently, investing in technology (e.g., using automatic dialing for follow-up telephone calls on delinquent accounts), assigning more experienced collection personnel to seriously delinquent accounts, moving quickly to foreclose or repossess collateral, and allowing few loan extensions. This aspect of subprime lending is very labor intensive but critical to the program's success. To a large extent, the cost of such efforts can represent a tradeoff relative to future loss expectations when an institution analyzes the profitability of subprime lending and assesses its appetite to expand or continue this line of business.

Subprime loan-administration procedures should be in writing and at a minimum should detail—

a. billing and statement procedures;
b. collection procedures;
c. content, format, and frequency of management reports;
d. asset-classification criteria;
e. methodology to evaluate the adequacy of the allowance for loan and lease losses (ALLL);
f. criteria for allowing loan extensions, deferrals, and re-agings;
g. foreclosure and repossession policies and procedures; and
h. loss-recognition policies and procedures.

6. *Loan review and monitoring*. Once loans are booked, institutions must perform an ongoing analysis of subprime loans, not only on an aggregate basis but also for subportfolios. Institutions should have information systems in place to segment and stratify their portfolio (e.g., by originator, loan-to-value, debt-to-income ratios, credit scores) and produce reports for management to evaluate the performance of subprime loans. The review process should focus on whether performance meets expectations. Institutions then need to consider the source and characteristics of loans that do not meet expectations and make changes in their underwriting policies and loan-administration procedures to restore performance to acceptable levels.

   When evaluating actual performance against expectations, it is particularly important that management review credit scoring, pricing, and ALLL adequacy models. Models driven by the volume and severity of historical losses experienced during an economic expansion may have little relevance in an economic slowdown, particularly in the subprime market. Management should ensure that models used to estimate credit losses or to set pricing allow for fluctuations in the economic cycle and are adjusted to account for other unexpected events.

7. *Consumer protection*. Institutions that originate or purchase subprime loans must take special care to avoid violating fair lending and consumer protection laws and regulations. Higher fees and interest rates combined with compensation incentives can foster predatory pricing or discriminatory ''steering'' of borrowers to subprime products for reasons other than the borrower's underlying creditworthiness. An adequate compliance-management program must identify, monitor, and control the consumer protection hazards associated with subprime lending.

   Subprime mortgage lending may trigger the special protections of the Home Ownership and Equity Protection Act of 1994, subtitle B of title I of the Riegle Community Development and Regulatory Improvement Act of 1994. This act amended the Truth in Lending Act to provide certain consumer protections in transactions involving a class of nonpurchase, closed-end home mortgage loans. Institutions engaging in this type of lending must also be thoroughly familiar with the obligations set forth in Regulation Z (12 C.F.R. 226.32), Regulation X, and the Real Estate Settlement Procedures Act (RESPA) (12 U.S.C. 2601) and adopt policies and implement practices that ensure compliance.

   The Equal Credit Opportunity Act makes it unlawful for a creditor to discriminate against an applicant on a prohibited basis regarding any aspect of a credit transaction. Similarly, the Fair Housing Act prohibits discrimination in connection with residential real estate related transactions. Loan officers and brokers must treat all similarly situated applicants equally and without regard to any prohibited basis characteristic (e.g., race, sex, age, etc.). This is especially important with respect to how loan officers or brokers assist customers in preparing their applications or otherwise help them to qualify for loan approval.

8. *Securitization and sale*. Some subprime lenders have increased their loan-production and -servicing income by securitizing and selling the loans they originate in the asset-backed securities market. Strong demand from

investors and favorable accounting rules often allow securitization pools to be sold at a gain, providing further incentive for lenders to expand their subprime-lending program. However, the securitization of subprime loans carries inherent risks, including interim credit risk and liquidity risk, that are potentially greater than those for securitizing prime loans. Accounting for the sale of subprime pools requires assumptions that can be difficult to quantify, and erroneous assumptions could lead to the significant overstatement of an institution's assets. Moreover, the practice of providing support and substituting performing loans for nonperforming loans to maintain the desired level of performance on securitized pools has the effect of masking credit-quality problems.

[T]urmoil in the financial markets [can illustrate] the volatility of the secondary market for subprime loans and the significant liquidity risk incurred when originating a large volume of loans intended for securitization and sale. Investors can quickly lose their appetite for risk in an economic downturn or when financial markets become volatile. As a result, institutions that have originated, but have not yet sold, pools of subprime loans may be forced to sell the pools at deep discounts. If an institution lacks adequate personnel, risk-management procedures, or capital support to hold subprime loans originally intended for sale, these loans may strain an institution's liquidity, asset quality, earnings, and capital. Consequently, institutions actively involved in the securitization and sale of subprime loans should develop a contingency plan that addresses back-up purchasers of the securities or the attendant servicing functions, alternate funding sources, and measures for raising additional capital.

Institutions should refer to Statement of Financial Accounting Standards No. 125 (FAS 125), "Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities," for guidance on accounting for these transactions. If a securitization transaction meets FAS 125 sale or servicing criteria, the seller must recognize any gain or loss on the sale of the pool immediately and carry any retained interests in the assets sold (including servicing rights/obligations and interest-only strips) at fair value. Management should ensure that the key assumptions used to value these retained interests are reasonable and well supported, both for the initial valuation and for subsequent quarterly revaluations. In particular, management should consider the appropriate discount rates, credit-loss rates, and prepayment rates associated with subprime pools when valuing these assets. Since the relative importance of each assumption varies with the underlying characteristics of the product types, management should segment securitized assets by specific pool, as well as predominant risk and cash-flow characteristics, when making the underlying valuation assumptions. In all cases, however, institutions should take a conservative approach when developing securitization assumptions and capitalizing expected future income from subprime lending pools. Institutions should also consult with their auditors as necessary to ensure their accounting for securitizations is accurate.

9. *Reevaluation*. Institutions should periodically evaluate whether the subprime-lending program has met profitability, risk, and performance goals. Whenever the program falls short of original objectives, an analysis should be performed to determine the cause and the program should be modified appropriately. If the program falls far short of the institution's expectations, management should consider terminating it. Questions that management and the board need to ask may include:
   a. Have cost and profit projections been met?
   b. Have projected loss estimates been accurate?
   c. Has the institution been called upon to provide support to enhance the quality and performance of loan pools it has securitized?
   d. Were the risks inherent in subprime lending properly identified, measured, monitored, and controlled?
   e. Has the program met the credit needs of the community that it was designed to address?

2190.05.4 INSPECTION OBJECTIVES

1. To assess and evaluate the extent of subprime-lending activities and whether management has adequately planned for this activity.
2. To determine whether the BO has the financial capacity, including capital adequacy, to

conduct the high-risk activity of subprime lending.
3. To establish whether management has committed the necessary resources with regard to technology and skilled personnel to manage the subprime-lending program.
4. To ascertain whether management has established adequate subprime-lending standards and is maintaining proper controls over the subprime-lending program.
5. To determine if the BO has contingency plans for subprime lending and if they are adequate for volatile financial markets and during economic downturns.
6. To review and evaluate the performance of the subprime-lending program, including its profitability, delinquency, and loss experience.

2190.05.5 INSPECTION PROCEDURES

1. Determine whether the subprime-lending activities are consistent with the banking organization's overall business strategy and risk tolerances, and that all critical business risks have been identified and considered.
2. Assess whether the BO has the financial capacity, including capital adequacy, to conduct the high-risk activity of subprime lending safely without any undue concentrations of credit.
3. Ascertain if management has committed the necessary resources in terms of technology and skilled personnel to manage and control the risks associated with the volume and complexity of the subprime-lending program.
4. Determine if management has established adequate lending standards that are appropriate for the size and complexity of the BO's operations and is maintaining proper controls over the program. See subsection 2190.05.3 for the lending standards that should be included in the subprime-loan program. See also section 2010.2 with regard to loan administration and lending standards.
5. Determine whether the BO's contingency plans are adequate to address the issues of (1) alternative funding sources, (2) back-up purchasers of the securities or the attendant servicing functions, and (3) methods of raising additional capital during an economic downturn or when financial markets become volatile.
6. Review and evaluate loan-administration and loan-monitoring procedures for subprime loans originated or purchased, including—
   a. collection, repossession, and disclosure procedures;
   b. management of the level and effective use of skilled staffing and advanced technology;
   c. the adequacy of the allowance for loan and lease losses; and
   d. the adequacy and accuracy of models used to estimate credit losses or to set pricing, making certain that the models account for economic cycles and other unexpected events.
7. Review securitization transactions for compliance with FAS 125 and this guidance, including whether the BO has provided any support to maintain the credit quality of loans pools it has securitized.
8. Analyze the performance of the program, including profitability, delinquency, and loss experience.
9. Consider management's response to adverse performance trends, such as higher-than-expected prepayments, delinquencies, charge-offs, customer complaints, and expenses.
10. Determine if the BO's subprime-lending program effectively manages the credit, market, liquidity, reputational, operational, and legal risks associated with subprime-lending operations.

2190.1.1 INTRODUCTION TO CREDIT-SUPPORTED AND ASSET-BACKED COMMERCIAL PAPER

The issuance of commercial paper provides an alternative to bank borrowing for large corporations (nonfinancial and financial) and municipalities. Generally, commercial paper issuers are those with high credit ratings. In recent years, however, some corporations with lower credit ratings have been able to issue commercial paper by obtaining credit enhancements (credit support from a firm with a high credit rating[1]) or other high-quality asset collateral (asset-backed commercial paper) to allow them to enter the market as issuers. An example of credit-supported commercial paper is one supported by a letter of credit (LOC), the terms of which specify that the bank issuing the LOC guarantees that the bank will pay off the commercial paper if the issuer fails to pay off the commercial paper upon maturity.[2] A credit enhancement could also consist of a surety bond from an insurance company.

2190.1.2 COMMERCIAL BANK INVOLVEMENT IN CREDIT-ENHANCED AND ASSET-BACKED COMMERCIAL PAPER

A number of commercial banks have become involved in credit-enhanced and asset-backed commercial paper programs. These securitization programs enable banks to help arrange short-term financing support for their customers without having to extend credit directly. This provides borrowers with an alternative source of funding and allows banks to earn fee income for managing the programs. Fees are earned for providing credit and liquidity enhancements to these programs.

It is important to emphasize that involvement in such programs can have potentially significant implications for the organizations' credit and liquidity risk exposure. Therefore, examiners need to be fully informed on the fundamentals of these programs, on the risks associated with these programs, and on the examination and inspection procedures for banking organizations engaged in this activity.

Asset-backed commercial paper programs have been in existence since the early 1980s and have grown substantially over the last few years. These programs use a special-purpose entity (SPE) to acquire receivables generally originated either by corporations or sometimes by the advising bank itself.[3] The SPEs, which are owned by third parties,[4] fund their acquisitions of receivables by issuing commercial paper that is to be repaid from the cash flow of the receivables.

Bank involvement in an asset-backed commercial paper program can range from advising the program to advising and providing all of the required credit and liquidity enhancements in support of the SPE's commercial paper. Typically, the advising bank, or an affiliate, performs a review to determine if the receivables of potential program participants (i.e., corporate sellers) are eligible for purchase by the SPE. The scope of the review is similar to that used in structuring credit card or automobile-loan-backed transactions.

Once the bank (or its affiliate) determines that a receivables portfolio has an acceptable credit-risk profile, it approves the purchase of the portfolio at a discounted price by the SPE. The bank or its affiliate may also act as the operating agent for the SPE. This entails structuring the sale of receivable pools to the SPE and then overseeing the performance of the pools on an ongoing basis.

The SPE pays for the receivables by issuing commercial paper in an amount equal to the discounted price paid for the receivables. The difference between the face value of the receivables and the discounted price paid provides, as discussed below, the first level of credit protection for the commercial paper. The individual companies selling their receivables traditionally act as the servicer for receivables sold to an SPE; that is, they are responsible for collecting principal and interest payments from the obli-

1. Such paper is usually called *credit-supported commercial paper*.
2. Usually referred to as *LOC paper*.
3. To date, the type of receivables that have been included in such programs are trade receivables, installment sales contracts, financing leases, and noncancelable portions of operating leases and credit card receivables.
4. Employees of an investment banking firm or some other third party generally own the equity of the SPE. The advising bank can specifically avoid owning the stock if it does not want to raise the issue of whether it must consolidate the SPE for accounting purposes.

gors and passing these funds on to the SPE on a periodic basis. The SPE then distributes the proceeds to the holders of the commercial paper.

Asset-backed commercial paper programs typically have several levels of credit enhancement cushioning the commercial paper purchaser from potential loss. As noted above, the first level of loss protection is provided by the difference between the face value of the receivables purchased and the discounted price paid for them, known as a ''holdback'' or ''overcollateralization.'' In some cases, the terms of the sale also give the SPE recourse back to the seller if there are defaults on the receivables. The amount of overcollateralization and recourse varies from pool to pool and depends, in part, upon the quality of the receivables in the pool and the desired credit rating for the paper to be issued. Usually, the level of credit protection provided by overcollateralization is specified in terms of some multiple of historical loss experience for similar assets.

In addition to overcollateralization and recourse, secondary credit enhancements are also customarily provided. Secondary credit enhancements include letters of credit, surety bonds, or other backup facilities that obligate a third party to purchase pools of receivables from the SPE at a specified price. In addition to credit enhancements, the programs also generally have liquidity enhancements to ensure that the SPE can meet maturing paper obligations.

The rating agencies typically require an SPE's commercial paper to have secondary enhancements aggregating 100 percent of the amount outstanding in order to receive the highest credit rating. These enhancements are generally structured in one of two ways. In the first, a commercial bank enters into a single agreement under which it is unconditionally obligated to provide funding for all or any portion of maturing commercial paper that an SPE cannot pay from other sources. The obligation to fund may be triggered by credit losses, a liquidity shortfall, or both. In the second, two separate agreements that jointly cover 100 percent of an SPE's outstanding commercial paper are established.

The first, typically an irrevocable letter of credit, is primarily intended to absorb credit losses that exceed the first tier of credit enhancement for the commercial paper. The second arrangement is a ''liquidity'' facility that may or may not provide credit support. This second structure will often have a letter of credit equalling 10 to 15 percent of outstandings, with the liquidity facility covering the remaining 85 to 90 percent.

2190.1.3 RISK-BASED CAPITAL TREATMENT FOR CREDIT-SUPPORTED AND ASSET-BACKED COMMERCIAL PAPER PROGRAMS

Generally, a single funding agreement that has no escape clause, such as a material-adverse-change clause that requires a bank to unconditionally provide funding to repay maturing commercial paper when the need arises because of either credit or liquidity problems should be treated as a direct credit substitute, or guarantee. The risk-based capital guidelines specify that the full amount of such obligations are to be converted to an on-balance-sheet credit-equivalent amount using a 100 percent conversion factor. No part of these arrangements should be considered commitments (either short-term or long-term) for risk-based capital purposes and assigned the conversion factor of a commitment. In the case of enhancements provided by separate facilities, a 100 percent conversion factor should be assigned to a letter of credit or any other form of credit guarantee provided by the bank. The accompanying liquidity facility, on the other hand, should be treated as a commitment and assigned a 50 percent conversion factor if over one year in maturity and a zero percent conversion factor if one year or less in maturity. One of the characteristics of liquidity facilities is that such arrangements generally have some reasonable asset-quality test that must be met before funds are extended to the SPE, to ensure that the bank is not providing credit protection.

2190.1.4 BOARD OF DIRECTORS' POLICIES PERTAINING TO CREDIT-ENHANCED OR ASSET-BACKED COMMERCIAL PAPER

A banking organization (i.e., a bank or bank holding company) participating in an asset-backed commercial paper program should ensure that such participation is clearly and logically integrated into its overall strategic objectives. Furthermore, the management should ensure that the risks associated with the various roles that the institution may play in such programs are fully understood and that safeguards are in place to manage these risks properly.

Appropriate policies, procedures, and controls should be established by a banking organi-

zation prior to participating in asset-backed commercial paper programs. Significant policies and procedures should be approved and reviewed periodically by the organization's board of directors. These policies and procedures should ensure that the organization follows prudent standards of credit assessment and approval regardless of the role an institution plays in an asset-backed commercial paper program. Such policies and procedures would be applicable to all pools of receivables to be purchased by the SPE as well as the extension of any credit enhancements and liquidity facilities. Procedures should include an initial, thorough credit assessment of each pool for which it had assumed credit risk, followed by periodic credit reviews to monitor performance throughout the life of the exposure. Furthermore, the policies and procedures should outline the credit approval process and establish ''in-house'' exposure limits, on a consolidated basis, with respect to particular industries or organizations, i.e., companies from which the SPE purchased the receivables as well as the receivable obligors themselves. Controls should include well-developed management information systems and monitoring procedures.

Institutions should analyze the receivables pools underlying the commercial paper as well as the structure of the arrangement.

This analysis should include a review of:

1. The characteristics, credit quality, and expected performance of the underlying receivables;

2. The banking organization's ability to meet its obligations under the securitization arrangement; and

3. The ability of the other participants in the arrangement to meet their obligations.

Banking organizations providing credit enhancements and liquidity facilities should conduct a careful analysis of their funding capabilities to ensure that they will be able to meet their obligations under all foreseeable circumstances. The analysis should include a determination of the impact that fulfillment of these obligations would have on their interest rate risk exposure, asset quality, liquidity position, and capital adequacy.

Examiners should review carefully the asset-backed commercial paper facilities provided by banking organizations to ensure that they are applying, for risk-based capital purposes, the proper conversion factors to their obligations supporting asset-backed commercial paper programs. In addition, examiners should determine whether the previously discussed policies are operative and that institutions are adequately managing their risk exposure. A discussion of the size, effectiveness and risks associated with these programs should be included in the confidential section of the examination/inspection report if not appropriate for the open section. Reference can be made to SR 92-11 as the source for this Manual section.

2190.1.5 INSPECTION OBJECTIVES

1. To determine whether the banking organization (i.e., a bank or bank holding company) participating in an asset-backed commercial paper program has included such participation in its overall strategic objectives.

2. To determine whether management fully understands the risks associated with the involvement in such credit enhancement and asset-backed commercial paper programs and whether appropriate safeguards are in place to properly manage those risks.

3. To ascertain that the appropriate policies, procedures, and controls have been established by the banking organization prior to participating in asset-backed commercial paper programs.

4. To verify whether existing managerial and internal controls include well-developed management information systems and monitoring procedures.

5. To determine whether the banking organization has conducted a careful analysis of its funding capabilities to ensure that they it will be able to meet its obligations under all foreseeable circumstances.

2190.1.6 INSPECTION PROCEDURES

1. Review the Board of Directors or Executive Committee minutes and establish whether the significant policies and procedures for credit enhanced or asset-backed commercial paper have been approved and reviewed periodically by the organization's board of directors.

a. Determine whether the policies are operative and that institutions are adequately managing their risk exposure.

b. Determine whether the policies and procedures are applicable to all pools of receivables to be purchased by the special purpose entity (SPE) as well as the extension of any credit enhancements and liquidity facilities.

2. Determine if the organization follows pru-

dent standards of credit assessment and approval.

a. Ascertain whether the procedures include an initial, thorough credit assessment of each pool for which it had assumed credit risk, followed by periodic credit reviews to monitor performance throughout the life of the exposure.

b. Determine if the policies and procedures outline the credit approval process and establish ''in-house'' exposure limits, on a consolidated basis, with respect to particular industries or organizations, i.e., companies from which the SPE purchased the receivables as well as the receivable obligors themselves.

c. Determine whether the organization analyzes the receivables pools underlying the commercial paper as well as the structure of the arrangement. Does the analysis include a review of:

(1) The characteristics, credit quality, and expected performance of the underlying receivables;

(2) The ability of the banking organization to meet its obligations under the securitization arrangement; and

(3) The ability of the other participants in the arrangement to meet their obligations?

3. Review the organization's funding obligations and commitments, and determine whether there is sufficient liquidity to satisfy those funding requirements. Include a determination of the impact that fulfillment of these obligations would have on their interest rate risk exposure, asset quality, liquidity position, and capital adequacy.

4. Review carefully the asset-backed commercial paper facilities to ensure that they are applying, for risk-based capital purposes, the proper conversion factors to their obligations supporting asset-backed commercial paper programs.

5. Include in the inspection report, a discussion of the size, effectiveness and risks associated with these programs in the confidential section of the inspection report if not appropriate for the open section.